Dissenting Views to H.R. 975
The "Bankruptcy Abuse Prevention and Consumer Protection Act of 2003"

Reform of the bankruptcy system, and the principle that every debtor should repay as much of her debt as she can reasonably afford, is a sound and uncontroversial idea. Were the legislation reported by the Judiciary Committee to bear any remote relationship to that laudable goal, this legislation would be wholly uncontroversial. Instead, by pressing legislation that is unbalanced and tilted toward specific special interest groups, the proponents of H.R. 975 have created a bill that would impose monumental costs on the parties in the bankruptcy system, including the government, subject the "honest but unfortunate debtor"[1] to coercion and loss of their legal rights, force businesses into unnecessary liquidation, and favor certain creditors over others.

For these reasons, and others discussed below, we respectfully dissent.

The sponsors of H.R. 975 have argued that the legislation is warranted by the increase in bankruptcy filings in recent years, the losses to borrowers, purported widespread abuse of the system and the costs which they claim are passed on to borrowers. They further claim that the bill "will help some of the most needy and deserving members in our society."[2]

Nonetheless, this legislation is opposed by organizations and individuals most concerned with the bankruptcy system, the rights of consumers, the needs of single parents and children, the elderly, working families, civil rights, and crime victims. Many of these concerns have been expressed since the introduction of the precursor bills since the 105th Congress. The reported bill is virtually identical to the conference report on H.R. 333 in the 107th Congress with the exception of an important provision that would have prevented the discharge, or the abuse of the bankruptcy system to hinder, delay and defraud creditors, of debts arising from violations of the Freedom of Access to Clinic Entrances Act[3]. There is no reason for the deletion of this amendment which reflects a compromise between Rep. Henry Hyde, Sen. Charles Schumer, and Sen. Orrin Hatch,

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[1] *Local Loan v. Hunt,* 292 U.S. 234 (April 30, 1934). "One of the primary purposes of the bankruptcy act is to 'relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.' The purpose of the act has been again and again emphasized by the courts as being of public as well as private interest, in that if gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt." *Id.* at 244. (Citations omitted).

[2] *Letter to Colleagues from Rep. F. James Sensenbrenner and Rep. Richard Boucher* (March 11. 2003).

[3] 18 USC 248.

other than the conclusion among the sponsors that protecting women's constitutional rights would interfere with the passage of this special interest legislation.

The bill as reported also makes 350 technical corrections of which we approve, but which do not in any way improve the substance of the legislation.[4]

Among the organizations that have opposed, or have expressed serious concerns with, H.R. 975 and its precursors since the 105th Congress are[5]:

(1) groups concerned about the rights of workers (such as the AFL-CIO; the American Federation of State, County, and Municipal Employees ("AFSCME"); the United Auto Workers ("UAW"); and the Union of Needletrades, Industrial and Textile Employees ("UNITE"));[6]

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[4]While the meticulous corrections, to which all members of the Committee agreed, are highly technical, we note that interpretation of the Bankruptcy Code has turned on the placement of commas. *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 241-2 (February 22, 1989). Nonetheless, we are concerned that the reckless manner in which this legislation has been drafted will lead to interminable litigation and perverse and unexpected results. If the sponsors wish to enact a bad policy, they have, at the very least, an obligation to execute that policy correctly.

[5]Letter from AFL-CIO, American Association of University Women, American Friends Service3 Committee, Association of Community Organization for Reform Now (ACORN), Business and Professional Women/USA, Center for Community Change, Children's Foundation, Church Women United, Commission on Social Action of Reform Judaism, Consumer Federation of America, Consumers Union, International Brotherhood of Boilermakers, International Union UAW, Leadership Conference on Civil Rights, Lutheran Office for Governmental Affairs ELCA, NAACP, National Advocacy Center of the Sisters of the Good Shepard, National Community reinvestment Coalition, National Consumer Law Center, National Council of Jewish Women, National Council of Women's Organizations, National Organization for Women, National Women's Law Center, Neighborhood Assistance Corporation of America, Network – a National Catholic Social Justice Lobby, NOW Legal Defense and Education Fund, OWL – Thee Voice of Midlife and Older Women, Public Justice Center, Transport Workers Union, Union of Needletrade Industrial and Textile Employees (UNITE), United Steelworkers of America, U.S. Public Research Group (March 3, 2003).

[6]Letter from Peggy Taylor, Director of Legislation, AFL-CIO, to the Honorable Henry J. Hyde, Chair, House Comm. on the Judiciary (Apr. 20, 1999); Letter from Charles M. Loveless, Director of Legislation, AFSCME, to Members of Congress (Apr. 19, 1999); Letter from Alan Reuther, Legislative Director, UAW, to Members of Congress (Apr. 26, 1999); Letter from Ann Hoffman, Legislative Director, UNITE, to the Honorable John Conyers, Jr., Ranking Member, House Comm. on the Judiciary (May 4, 1998).

(2) groups of non-partisan bankruptcy lawyers, judges, and academics (such as the National Bankruptcy Conference ("NBC"), the American Bankruptcy Institute ("ABI"), the National Conference of Bankruptcy Judges ("NCBJ"), the National Association of Chapter 13 Trustees ("NACTT"), the National Association of Bankruptcy Trustees ("NABT"), the Commercial Law League of America, the American College of Bankruptcy, and the National Association of Consumer Bankruptcy Attorneys ("NACBA"));[7]

(3) groups concerned about the rights of women, children, and victims of crimes and torts (such as the National Women's Law Center, the National Partnership for Women and Families, the National Organization for Women ("NOW"), the Association for Children for Enforcement of Support ("ACES"), the California Women's Law Center, Mothers Against Drunk Driving ("MADD"), the National Organization for Victim Assistance ("NOVA"), and the National Victim Center);[8] and

(4) consumer and civil rights organizations (such as the Leadership Conference on

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[7]Letter from Douglas G. Baird, Vice Chair, NBC, to the Honorable Henry J. Hyde, Chair, House Comm. on the Judiciary (Apr. 19, 1999); *Hearing on H.R. 833, the "Bankruptcy Reform Act of 1999," Before the House Subcomm. on Commercial and Admin. Law*, 106th Cong., 1st Sess. (Mar. 17, 1999) [hereinafter *March 17, 1999 Hearing*] (written statement of the Honorable William Houston Brown, ABI); *Id.* (written statement of the Honorable Randall J. Newsome, NCBJ; *Id.* (written statement of Henry E. Hildebrand, III, NACTT); *Id.* (written statement of Robert H. Waldschmidt, NABT); COMMERCIAL LAW LEAGUE OF AMERICA, POSITION PAPER ON THE BANKRUPTCY REFORM ACT OF 1999, H.R. 833, SUBMITTED TO THE U.S. HOUSE OF REPRESENTATIVES AND THE U.S. SENATE (Mar. 9, 1999); Letter from Raymond L. Shapiro, Chair, American College of Bankruptcy, to Members of Congress (Apr. 26, 1999); Letter from Norma Hammes, President, NACBA, to Members of Congress (Apr. 26, 1999).

[8]Letter from the National Women's Law Center & the National Partnership for Women and Families to the Honorable John Conyers, Jr., Ranking Member, House Comm. on the Judiciary (Apr. 19, 1999); Letter from Patricia Ireland, President, NOW, to the Honorable John Conyers, Jr., Ranking Member, House Comm. on the Judiciary (May 15, 1998); Letter from Geraldine Jensen, President, ACES, to the Honorable George W. Gekas, Chair, House Subcomm. on Commercial and Admin. Law (Mar. 17, 1999); Letter from Abby J. Leibman, Executive Director, California Women's Law Center, to the Honorable Dianne Feinstein, Senate Comm. on the Judiciary (Apr. 27, 1998); Letter from Karolyn V. Nunnallee, National President, MADD, to Members of Congress (Apr. 26, 1999); Letter from Marlene A. Young, Executive Director, NOVA, to the Honorable Henry J. Hyde, Chair, House Comm. on the Judiciary (Apr. 26, 1999); Letter from David Beatty, Director of Public Policy, The National Center for Victims of Crime, to the Honorable Jerrold Nadler, Ranking Member, House Subcomm. on Commercial and Admin. Law (Apr. 28, 1999).

Civil Rights ("LCCR"), National Consumer Law Center, Consumers Union, the Consumer Federation of America, U.S. Public Interest Research Group ("U.S. PIRG"), Public Citizen, the Alliance for Justice, and the National Council of Senior Citizens).[9]

Section I of describes concerns about the lack of empirical justification for this bill. Section II describes the consumer provisions, including, most notably, the means test. Section III discusses flaws in the small business and single-asset real estate provisions, and Section IV turns to the tax sections of H.R. 975. The following is a table of contents summarizing this analysis:

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[9]Letter from the Leadership Conference on Civil Rights to Members of Congress (March 12, 2003); Letter from Gary Klein, Senior Attorney, National Consumer Law Center, to Members of Congress (Apr. 23, 1999); Letter from Consumer Federation, Consumers Union, and U.S. Public Interest Group (March 11, 2003);Letter from Frank Clemente, Legislative Director, Public Citizen, to House Comm. on the Judiciary (May 11, 1998); Letter from Nan Aron, President, Alliance for Justice, to Members of the Senate Comm. on the Judiciary (Apr. 23, 1998); Letter from Dan Schulder, Director Legislation, National Council of Senior Citizens, to the Honorable Jerrold Nadler, Ranking Member, House Subcomm. on Commercial and Admin. Law (June 9, 1998).

I. LACK OF EMPIRICAL JUSTIFICATION

One of the major reasons accounting for the differing views regarding H.R. 975 relates to differing understandings of the quantitative evidence of the causes, costs, and effects of bankruptcy. H.R. 975's proponents point to (1) the fact that the United States is experiencing a dramatic growth in the number of bankruptcy filings (an increase by 150% to more than 1.5 million filings in 2002),[10] and (2) credit industry-funded studies by Professor Michael Staten of Georgetown University's Credit Research Center,[11] Ernst & Young,[12] and the WEFA[13] group

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[10]According to the Administrative Office of the U.S. Courts, in the calendar year 2002 there 1,109,923 personal chapter 7 filings, 984 personal chapter 11 filings, and 450, 516 personal chapter 13 filings in 1998. Press Release of the Administrative Office of the U.S. Courts (Feb. 12, 2003. Personal bankruptcy filings represented 97.6% of all filings in 2003. *Id.*

[11]Professor Michael E. Staten of Georgetown University's Credit Research Center ("CRC"), which has many credit industry officials on its board, conducted what is perhaps the most-discussed study. JOHN M. BARRON & MICHAEL E. STATEN, PURDUE UNIVERSITY CREDIT RESEARCH CENTER, PERSONAL BANKRUPTCY: A REPORT ON PETITIONERS' ABILITY TO PAY (Oct. 1997); *see also March 17, 1999 Hearing* (written statement of Michael E. Staten). Staten concluded that 5% of chapter 7 debtors could repay all of their non-priority, non-housing debt over 5 years, 10% could repay at least 78% of such debt, and 25% could repay 30% of their debt.

[12]An Ernst & Young study, funded by VISA USA and MasterCard International, purports to corroborate the CRC findings. Policy Economics and Quantitative Analysis Group, *Chapter 7 Bankruptcy Petitioner's Ability to Repay: Additional Evidence from bankruptcy Petition Files*, Ernst & Young LLP (Feb. 1998).

[13]Wharton Econometric Forecasting Associates ("WEFA") examined the financial cost of personal bankruptcy cases filed in 1997, which it defined as "the amount of credit dollars (outstanding loans) lost due to bankruptcy filings . . . [and] the costs of the U.S. court system . . . and other creditor's expenses relating to bankruptcy." WEFA Group Resource Planning Service, *The Financial Costs of Personal Bankruptcy* 4 (Feb. 1998). The WEFA study calculated that "financial losses due to 1997 personal bankruptcies totaled more than $44 billion. . . . Unsecured nonpriority losses totaled almost $35 billion in 1997 . . . [and] passing such financial losses on to consumers in terms of higher prices would cost the average household over $400 annually." *Id.*

that purport to demonstrate that the bankruptcy laws allow many relatively high income individuals to avoid debts they could otherwise pay and that this avoidance imposes substantial costs on the economy. Proponents of H.R. 975 point to the "opportunistic personal filings" for bankruptcy and the declining stigma associated with doing so to explain the increase in filings.[14]

Despite the earlier trend in higher numbers of bankruptcy filings, the vast weight of studies have contradicted the proponents' rationales and have shown that the increasing filing rate is a symptom, not a root cause, of financial difficulties. Analysts with the Congressional Budget Office,[15] the General Accounting Office,[16] and the Federal Deposit Insurance

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at 1. The WEFA study also concluded that the needs based proposal in H.R. 3150 "should decrease financial costs due to bankruptcy . . . from 8% to 17% annually." *Id*. at 2.

[14]*Hearing on H.R. 833, the "Bankruptcy Reform Act of 1999," Before the House Subcomm. on Commercial and Admin. Law*, 106th Cong., 1st Sess. (Mar. 17, 1999) (written statement of Michael E. Staten); *Joint Hearing Before the House Subcomm. on Commercial and Admin. Law and the Senate Subcomm. on Admin. Oversight and the Courts*, 106th Cong., 1st Sess. (Mar. 11, 1999) (written statements of (1) Bruce L. Hammonds, Senior Vice Chairman of MBNA Corporation; (2) Judge Edith H. Jones, U.S. Court of Appeals for the Fifth Circuit; (3) Professor Todd J. Zywicki, George Mason University School of Law; and (4) Dean Sheaffer, National Retail Federation). *See also* "Dear Colleague," dated February 27, 2003, from Chairman F. James Sensenbrenner and Congressman Rick Boucher ("There is a perception that bankruptcy relief is too readily available and the it is sometimes used as a first resort, rather than a last resort.").

[15]Kim Kowalewski of the Congressional Budget Office ("CBO"), at the request of the National Bankruptcy Review Commission, conducted a review of three economic analyses of this question. Kowalewski concluded that a 1996 VISA study did not support such a conclusion and, in fact, "because the social trends variable is flat during 1995 and early 1996, VISA believes that their social factors played no role behind the increase in personal bankruptcies in that period." Kim J. Kowalewski, *Evaluations of Three Studies Submitted to the National Bankruptcy Review Commission* 4 (Oct.6, 1997). At the request of Subcommittee Democrats, Mr. Kowalewski reviewed the economic issues affecting the rate and nature of bankruptcy in the United States. The Democratic Members made their original request on January 14, 1998; the response from CBO, in draft form only, was delivered April 16, 1999, over one year later. Mr. Kowalewski has still not been made available to testify before the Committee.

[16]At the request of Senators Charles Grassley and Richard Durbin, the General Accounting Office ("GAO") examined the CRC study and found five areas of concern: (1) data supplied by the debtors regarding their income expenses, and debts and the stability of their income and expenses over a 5-year period were not validated, (2) the report did not define the universe of debts for which it estimated debtors' ability to pay, (3) payments on non-housing debts that debtors stated they intended to reaffirm were not included in debtor expenses in determining the

Corporation all have called into question the conclusions of those studies. These critiques focus on a number of grounds, including numerous flaws in the analysis and the assumptions underlying the studies. Moreover, other analyses indicate that the rise in bankruptcies is more properly attributable to a number of changes unrelated to the bankruptcy laws, such as unexpected medical costs, family crises like divorce, loss of high paying full time jobs, and most notably, the deregulation of credit card interest rates and the dramatic increase in credit card solicitations and overall consumer debt.[17] Even a credit card industry official found that "[t]he majority of bankruptcies in [its] file are on customers who have been on the books for more than three years and have had some significant change in their financial condition."[18] It also has been shown that the average income of persons filing for bankruptcy has declined from the 1980's, further contradicting assertions of widespread abuse by high-income individuals.[19]

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net income debtors had, (4) the CRC did not account for the considerable variation among the 13 locations used in the analysis, and (5) a scientific random sampling methodology was not used to select the 13 bankruptcy locations or the bankruptcy petitions used in the analysis. GENERAL ACCOUNTING OFFICE, PERSONAL BANKRUPTCY: THE CREDIT RESEARCH CENTER REPORT ON DEBTORS' ABILITY TO PAY, GAO/GGD-98-47 (Feb. 1998).

[17]The Federal Deposit Insurance Corporation ("FDIC") contested many of assertions made in the above-noted studies. FEDERAL DEPOSIT INSURANCE CORP., BANK TRENDS (Mar. 1998); Lawrence M. Ausubel, *Credit Card Defaults, Credit Card Profits, and Bankruptcy*, 71 American Bankruptcy L.J. 249 (1997). The FDIC observed a strong correlation between credit card default rates and personal bankruptcies, both of which increased in the 1990's. The FDIC found that, because of and following interest rate deregulation in 1978, credit card companies became more profitable and credit card lenders were able to extend more unsecured credit to less creditworthy borrowers.

[18]*March 11, 1999 Hearing* (written statement of Bruce L. Hammonds, Senior Vice Chairman, MBNA Corporation).

[19]While bankruptcy rates have been on the rise as a result of the current recession both the American Bankruptcy Institute and Professor Ausubel pointed out, however, that the earlier rise in personal bankruptcy rates, which were used to manufacture fear of a so-called bankruptcy crisis, in fact ended in 1998. AMERICAN BANKRUPTCY INSTITUTE, 18 ABI JOURNAL 1 (Apr. 1999); LAWRENCE M. AUSUBEL, UNIVERSITY COLLEGE LONDON, A SELF-CORRECTING "CRISIS": THE STATUS OF PERSONAL BANKRUPTCY IN 1999 1 (Mar. 10, 1999). In fact, the ABI found that "consumer bankruptcy filings have dropped dramatically nationwide in January and February [1999], after three consecutive years of record filings." AMERICAN BANKRUPTCY INSTITUTE, *supra*, at 1. Specifically, "[t]he personal bankruptcy filing rate per thousand population grew at an annual rate of only 1.5% in the last year, and at a (seasonally-adjusted) annual rate of only 1.0% in the last quarter." LAWRENCE M. AUSUBEL, *supra*, at 1. The crisis corrected itself because lenders, as they normally would, tightened their lending practices when defaults became more common and infringed upon profits, thereby limiting the number of people going into debt

One of the most telling studies was performed by the non-partisan American Bankruptcy Institute commissioned Professors Marianne B. Culhane and Michaela M. White of the Creighton University School of Law to conduct a study independent of the credit industry.[20] Professors Culhane and White used for their study a database of chapter 7 cases; the National Conference of Bankruptcy Judges funded the compilation of the database. The study estimated that 3.6% of the debtors in their sample had sufficient income, after deducting allowable living expenses, to pay all of their non-housing secured debts, all of their unsecured priority debts, and at least 20% of their unsecured nonpriority debts. Moreover, in making their calculations, Professors Culhane and White assumed that 100% of the debtors in chapter 13 would complete a five-year repayment plan even though more than 60% of voluntary chapter 13 plans currently do not complete. These figures are significantly lower than those of the Credit Research Center and VISA – two entities that had financial stakes in their own bankruptcy studies – and show that the credit industry may have overstated the "problem" by as much as 500%.

The American Bankruptcy Institute study also showed that, while the credit industry estimates it may be eligible recover $4 billion under the rigid standards of the means test, creditors would receive only $450 million in actual collections.[21] The Executive Office of United States Trustees in the Justice Department conducted a study that reached similar results, estimating that passage of the Conference Report probably would have netted creditors no more than 3% of the $400 per household they claim to be losing. These findings call into question the hundreds of millions of dollars in bureaucratic expenses the means test would require of both government and private citizens.

Recently, Prof. Staten, whose work for the credit industry provided much of the empirical fodder for this legislation, observed that this legislation would only move about 5% of all ch. 7 cases into ch. 13, and that the legislation would have not effect on the number of bankruptcies.[22]

Similarly, according to James Blaine, CEO of the NC State Employees Credit Union, "Charge-offs, too, are well under control at .46% of total loans (less than 1%). In other words, 99.5% of credit union loans are repaid as promised. According to NCUA 41.1% of credit union charge-offs related to bankruptcy. Or said another way, just .19% (less than 2/10th of 1%!) of

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and filing for bankruptcy. *See id.* at 3.

[20]*March 17, 1999 Hearing* (written statement of Marianne B. Culhane); MARIANNE B. CULHANE & MICHAELA M. WHITE, TAKING THE NEW CONSUMER BANKRUPTCY MODEL FOR A TEST DRIVE: MEANS-TESTING REAL CHAPTER 7 DEBTORS (Mar. 8, 1999).

[21]Culhane and White, "Means Testing for Chapter 7 Debtors: Repayment Capacity Untapped?" (American Bankruptcy Institute, 1998).

[22]*FDIC Roundtable On Consumer Debt* (Statement of Michael Staten)(Feb. 28, 2003).

total credit union loans result in a bankruptcy loss. So taking a the high estimate of 15% rate of abuse, he calculates that total losses on loan portfolios are .0385% or less than 3/100ths of 1% (.19% x 15% = .0285% (less than 3/100ths of 1%)".[23]

Notwithstanding claims by the consumer credit industry to the contrary, consumer lending is their most profitable enterprise. According to Bloomberg News:

> Citigroup Inc. said fourth- quarter profit fell 37 percent because of higher loan losses and the cost of settling claims that the world's biggest financial- services company misled customers with biased stock research.
>
> Net income declined $2.43 billion, or 47 cents a share, from $3.88 billion, or 74 cents, in the year-ago quarter, the New York- based company said. Revenue was $18.93 billion, little changed, as fees from credit cards and mortgage lending rose while its Salomon Smith Barney Inc. unit had a loss.
>
> For Chairman and Chief Executive Sanford Weill's bank, businesses aimed at consumers contributed about 98 percent of net income.
>
> The company also took a $1.3 billion after-tax charge to set up a reserve to pay for the settlement with regulators and related civil litigation as well as private litigation related to Enron. The reserve was announced last month.
>
> The Salomon Smith Barney securities unit lost $344 million as revenue declined 9 percent to $4.66 billion. Citigroup includes corporate lending in its investment banking results.
>
> Profit from the global consumer business, including credit cards, home lending and fees generated through 459 Citibank branches, rose 26 percent to $2.37 billion.
>
> Credit card earnings rose 30 percent to $939 million, branch profit rose 25 percent and consumer-finance earnings rose 15 percent.[24]

Based on this report it appears that consumer borrowers are not subsidizing other consumers who are filing for bankruptcy relief. Rather it appears that consumer borrowers are subsidizing losses due to bad investments and penalties.

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[23]Jim Blaine, 'Only Thing Bankrupt Is Logic Behind 'Reform' *Credit Union Journal,* 23 (February 24, 2003).

[24]George Stein "CitiGroup Net Falls on Loan Loss Settlement Costs" *Bloomberg News* , January 21, 2003.

There is nothing in this bill to guarantee that any savings realized from this bill will be passed on to consumers. The bill does not require it and, quite frankly, although real interest rates are at record lows, none of those savings have been passed on to credit card borrowers. There is no guarantees that consumers have that any increased returns would be passed on the form of reduced interest rates or other fees. Yet the proponents of this legislation have never been willing to accept a provision requiring such a passalong to ensure that the proponents of this bill do not reap a windfall.

Finally, we have never received any evidence that the credit card industry likely would pass on any of the "savings" from bankruptcy law changes to individual debtors. Instead the evidence shows that credit card companies, which represent by far the most profitable sector of the commercial banking business,[25] tend to maintain high interest rates, even when their own cost of credit declines.[26] The lack of competition in this industry has caught even the Justice Department's attention, which has brought an antitrust suit against VISA and MasterCard in the Southern District of New York.[27]

II. CONSUMER PROVISIONS

A. Current Law and Proposed Changes

Under current law, individuals facing financial difficulty may seek a variety of forms of relief under the bankruptcy laws, with chapter 7 (liquidation) being by far the most common form of relief sought. Under this chapter, debtors are required to forfeit all of their property other than their "exempt" assets (*i.e.*, deemed necessary for the debtor's maintenance, as determined under federal or state law, at the state's option) in exchange for receiving a

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[25]In 1993, credit card banks were nearly four times as profitable as all commercial banks. Despite the slight decrease in the average credit card interest rate, credit card banks remain twice as profitable as commercial banks. *March 16, 1999 Hearing* (written statement of the Honorable Joe Lee) (citing FEDERAL RESERVE BOARD, THE PROFITABILITY OF CREDIT CARD OPERATIONS OF DEPOSITORY INSTITUTIONS (Aug. 1997)).

[26]In 1996, Professor James Medoff, the Meyer Kestnbaum Professor of Labor and Industry at Harvard University, pointed out that, between 1980 and 1992, when the federal funds rate (the interest that banks charge for overnight loans) fell from 13.4% to 3.5%, a drop of nearly 10 percentage points, the average credit card interest rate rose from 17.3% to 17.8%. Professor Medoff suggests that during the 1980s, when interest rates were high, lenders learned a valuable lesson; consumer debtors in general pay very little attention to interest rates. *March 16, 1999 Hearing* (written statement of the Honorable Joe Lee at 1) (citations omitted).

[27]Kenneth N. Gilpin, "*Antitrust Suit Filed Against VISA and MasterCard*," N.Y. TIMES, Oct. 8, 1998, at C1.

discharge of their unsecured debts. Creditors are entitled to receive any net proceeds from the sale of the debtor's nonexempt property, subject to the statutory priority schedule.[28] The Bankruptcy Code does not permit the discharge of certain debts whose payments are considered to be important to society. Some of this debt is of the same nature as priority debt (*e.g.*, family support obligations and taxes), but the law also excepts from discharge debts incurred through the debtor's misconduct, such as debts arising from fraud and intentional injuries.

While the decision to seek relief under ch. 7 or ch. 13 is voluntary at the discretion of the debtor, § 707(b) of the Bankruptcy Code grants the court the discretion to deny relief where the filing is found to be a "substantial abuse."[29] Under § 707(b), however, there is a presumption *in favor of* granting relief to the debtor. This stems in part from the costs and potential hardships associated with developing excessive barriers to chapter 7 eligibility, the belief that the "honest but unfortunate debtor" should be entitled to a "fresh start," the importance of encouraging risk-taking and entrepreneurship, and avoiding situations where it is impossible for individuals to escape aggressive creditor collection tactics.[30] Section 707(b) is not the only provision in the Bankruptcy Code that prevents individuals from misusing chapter 7. For example, creditors may request that certain debts be held nondischargeable under § 523(a) or that the debtor be denied a discharge altogether under § 727.

A separate bankruptcy alternative available to individual debtors is chapter 13, which was formerly known as a wage earner's plan.[31] Under chapter 13, a debtor is permitted to retain his or her property, but is required to pay to creditors over a 3-5 year period out of future

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[28]For example, the costs of administering the estate are entitled to the first priority, and payments of alimony, child support, and taxes are entitled to later priorities, with general unsecured debt entitled to any residual assets left over. 11 U.S.C. § 507(a).

[29]The Code does not define the term "substantial abuse," which is used in § 707(b), although, some courts have found that the ability to pay an appreciable proportion of one's debts over three years, using future income, could constitute "substantial abuse." *See, e.g., Fonder v. United States*, 974 F.2d 996 (8th Cir. 1992) (debtor could pay 89% of unsecured debts in three years); In re Krohn, 886 F.2d 123 (6th Cir. 1989) (ability to pay portion of debts from "ample income" in excess of $80,000 per year); In re Walton, 866 F.2d 981 (8th Cir. 1989) (ability to pay two thirds of debts in three years).

[30]There are a number of disincentives to filing for bankruptcy, such as the fact that a person filed for a chapter 7 bankruptcy will be disclosed on a debtor's credit report, and the law's prohibitions on repeat chapter 7 filings for six years.

[31]The eligibility requirements for chapter 13 may be found in 11 U.S.C. § 109(e). To be eligible for chapter 13, an individual must have regular income and noncontingent, liquidated, unsecured debts of less than $290,525 and secured debts of less than $871,550. Individuals with debts in excess of the ch. 13 limits must reorganize under chapter 11.

income at least as much as the creditors would have received under a chapter 7 liquidation, and is also required to pay all priority debts in full. To accomplish this, the debtor must propose a plan, administered by a trustee, that pays creditors in full or that devotes the debtor's "disposable income" after accounting for necessary support of the debtor, his or her family, or a business. In order to encourage the use of chapter 13 plans, which are currently voluntary to the debtor, Congress determined that persons who meet their chapter 13 obligations are entitled to a broader discharge of their unpaid debts than is available under chapter 7. This "superdischarge" results in the discharge of several types of debt that chapter 7 does not discharge. In addition, debtors are permitted to retain property whether or not the property is encumbered by liens and the debtor committed a prepetition default, so long as the chapter 13 plan cures any arrearages. In this manner, debtors can use chapter 13 to save their homes from foreclosure. In addition, in chapter 13 a debtor is permitted to bifurcate a loan on personal property, such as an automobile, into secured and unsecured portions based on its present value, and treat only the secured portion as a secured claim that must be paid in full with interest.[32] Also, chapter 13 plans can provide for the payment of priority debts, such as taxes and family support obligations, before payment on general unsecured debts.

H.R. 975 would institute a number of major changes to consumer bankruptcy, in general, and chapter 7 and 13, in particular, that some have argued may reduce the number of bankruptcy filings (but will not reduce the number of cases of financial hardship) and that are likely to serve as procedural and legal impediments to bankruptcy relief. These changes are designed to increase pay-outs to non-priority unsecured creditors, particularly credit card companies, as well as to certain secured lenders, especially those extending credit for automobile loans.

1. Means Testing

The most far-reaching change, set forth in section 102 of the bill, would institute a so-called "means testing" approach to consumer bankruptcy.[33] This new standard would create a presumption of abuse of the bankruptcy system and deny chapter 7 relief to debtors who fail a "means test." The means test applies only to debtors with primarily consumer debts. The means test in general works as follows:

First, the debtor's "current monthly income" is computed. This is the average of the

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[32]This is known as a "stripdown." Specifically, except for certain home mortgages, a debtor in chapter 13 may be able to bifurcate a debt to a secured creditor, treating only the *current value* of the collateral as secured, even if it is less than the full amount of the loan, and treating the remaining debt as a non-priority unsecured debt.

[33]Subsection (a) of section 102 amends section 707(b) of the Bankruptcy Code to permit a court, on its own motion, or on motion of the United States trustee, private trustee, bankruptcy administrator, or party in interest, to dismiss a chapter 7 case for abuse if it was filed by an individual debtor whose debts are primarily consumer debts.

debtor(s)' monthly income over the last six months before the bankruptcy, excluding social security benefits, reparations to victims of war crimes and crimes against humanity, and payments to victims of terrorism.

Second, the debtor's expenses, as provided in the IRS National Standards and Local Standards and the IRS Other Necessary Expenses rather than the debtors actual expenses not to include:

a. total priority debts divided by 60
b. the scheduled payments on secured debts over the next 60 months, divided by 60
c. arrears on secured debts such as mortgages and car payments
d. monthly expenses permitted by the Internal Revenue Service collection guidelines, with possible 5% increase for food and clothing allowances if demonstrated to be "reasonable and necessary", long-term care expenses for the elderly or chronically ill, expenses due to domestic violence, and private school expenses up to $1500 per child annually if there is an explanation of why they are reasonable and necessary, documented home energy costs in excess of the IRS allowance, and health insurance costs.
e. if debtor is eligible for chapter 13, hypothetical administrative expenses for chapter 13, but only up to 10% of projected plan payments.

All of the calculations must be done as part of the debtor's schedules. If after deducting the allowed expenses, the debtor has enough "disposable income" over 60 months to pay either the greater of 25% of the debtor's nonpriority unsecured claims or $6,000, or, if it is more than the 25%, $10,000.

Put more plainly, if the debtor is able to pay as little as $100 per month to non-priority unsecured creditors (such as credit card banks) for five years, after working through a means test that relies neither on her real income nor her real expenses, the debtor will be presumed to have "abused" ch. 7, and will be subject to dismissal or conversion to ch. 13.

If a debtor is presumed to be abusing chapter 7, the U.S. trustee must move to dismiss or file a report about why no motion is filed. Any creditor may also move to dismiss under the means test. However, no motion under §707(b) may be filed by a creditor if the debtor(s) are under state median income. No motion under the means test may be filed by a trustee or U.S. trustee if the current monthly income of the debtor and the debtor's spouse is less than the state median income. If a motion is filed under the means test, the court has little discretion to deny it. The presumption of abuse can be overcome only if there are "special circumstances" that can be documented that require adjustment of the debtor's income or expenses for which there is "no reasonable alternative."

Although the means test is only applicable above median income,[34] all debtors must complete the means test calculations. This gives rise to the possibility that trustees or U.S. trustees will bring motions for abuse under §707(b)'s new looser standard ("totality of the circumstances" or "bad faith") and use the means test calculations to support the argument that the debtor could afford to pay creditors, especially since chapter 7 trustees could receive compensation under the chapter 13 plan.

The bill also makes substantial changes to ch. 13 by substituting the IRS expense standards to calculate disposable income, rather than the existing standard that uses the debtor's actual expenses "reasonably necessary for the maintenance and support of the debtor or a dependant of the debtor.[35]

Accordingly, under section 102(h) of the bill, debtors would be required to dedicate all of their available income to unsecured debt, again after allowing deductions for secured and priority debts and living expenses per the means test and its IRS collection standards, even if the debtor's actual reasonably necessary expenses exceed the IRS permitted, but arbitrarily-created, expenses.[36] Although the provisions clarifying the means test allow for adjustments for "special circumstances that require additional expenses or adjustments of current monthly total income, for which there is no reasonable alternative," no such appeal is available under the revised 1325(b). Under the revised 707(b) the debtor would be required to file a motion with the court to rebut the presumption of abuse, which may be challenged by the trustee or any creditor, with the burden of proof lying with the debtor.[37]

The bill also goes on for these debtors to calculate the means test using expenses over 5 years rather than 3 years. That guarantees that, if the means test pushes a debtor into chapter

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[34]Two forms of "safe harbors" are recognized under section 102(a). One provides that only a judge, United States trustee, bankruptcy administrator, or private trustee may bring a motion under section 707(b) of the Bankruptcy Code if the chapter 7 debtor's income (or in a joint case, the income of debtor and the debtor's spouse) does not exceed the state median family income for a family of equal or lesser size (adjusted for larger sized families), or the state median family income for one earner in the case of a one-person household. The second safe harbor provides that no motion under section 707(b)(2) may be filed by a judge, United States trustee, bankruptcy administrator, private trustee, or other party in interest if the debtor and the debtor's spouse combined have income that does not exceed the state median family income for a family of equal or lesser size (adjusted for larger sized families), or the state median family income for one earner in the case of a one-person household.

[35]11 USC 1325(b).

[36]H.R. 975, § 102(h) (proposed amendment to 11 U.S.C. § 1325(b)).

[37]H.R. 975, § 102 (proposed amendment to 11 U.S.C. § 707).

13, the repayment capacity assumptions would force the debtor into a five-year repayment plan. This legislation also greatly curtails the broader discharge currently available to debtors who have successfully completed a chapter 13 plan, eliminating a significant inducement for voluntary debtor participation in chapter 13.[38]

2. Exceptions to Discharge & Loan Bifurcations

H.R. 975 would make two significant additions to the types of debts that a debtor may not discharge under chapters 7 or 13 and proscribe a debtor's ability to bifurcate a loan into secured and unsecured portions based upon the value of the collateral.

Section 310 would create a presumption of non-dischargeability for credit card debts of $500 or more in the aggregate (as opposed to $1,150 under current law) or more owed to a single creditor for "luxury goods or services" incurred within 90 days prior to the bankruptcy filing (as opposed to 60 days under current law).[39] Additionally, §310 also makes presumptively nondischargeable cash advances aggregating at least $750 incurred within 70 days before the order for relief, to one or more creditors in an open-ended credit plan. This means that, if a debtor uses several cards to purchase basic household needs (there is no requirement that these cash advances be used for luxury goods) over a 70 day period, even if the debt to each creditor is a fraction of the $750 threshold, all the debts would be nondischargeable. Current law makes cash advances aggregating more than $1,150 nondischargeable if they are incurred within 90 days before the order for relief.[40] Section 314 adds another exception to discharge when the "debtor incurred the debt to pay a tax to a governmental unit that would be nondischargeable."[41] Therefore, regardless of the debtor's intent, any debts incurred to pay a nondischargeable tax debt would be nondischargeable.[42] This particular change will have a devastating impact on taxpayers who, at the urging of the IRS, pay their taxes electronically using a credit card.

The legislation would also largely eliminate the possibility of loan bifurcations in chapter 13 cases. Under current law a debtor is permitted to bifurcate a loan between the secured and unsecured portions. The debt is treated as a secured debt up to the value of the property securing the debt. The remainder of the debt is treated as a non-priority unsecured debt. Section 306 of the legislation prevents such bifurcations (including with regard to interest and penalty provisions) with respect to any loan for the purchase of a vehicle in the 2 years before

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[38]H.R. 975, § 314(b) proposed amendment to 11 U.S.C. § 1328(a)).

[39]H.R. 975, § 310 (proposed amendment to 11 U.S.C. § 523(a)(2)(C)).

[40]11 U.S.C. 523(a)(2)(C).

[41]H.R. 975, § 314 (proposed amendment to 11 U.S.C. § 523(a)).

[42]H.R. 975, § 315.

bankruptcy, as well as all loans secured by other property incurred within one year before bankruptcy.

3. Domestic Support

Sections 211-219 of the bill make a number of changes to current law are purportedly intended to enhance the status of child support and alimony payments in bankruptcy. These changes are presumably being made in an effort to offset the considerable criticism the legislation has received from children and family advocates.

Section 211 creates a new definition of "domestic support obligation."[43] In addition to applying to debts owed on account of child support and alimony, which are already nondischargeable under current law[44], the new definition includes alimony and child support debts owed or recoverable to a governmental unit.[45] This definition is in turn relevant to new sections of the Bankruptcy Code that give certain enhanced rights to the holders of domestic support obligations in terms of priorities, payments, automatic stay, preferences, and foreclosure placing the rights of children and custodial parents in conflict with the claims of governmental entities.[46]

Section 212 grants alimony and child care creditors a first priority in bankruptcy (they are currently seventh, although most of the higher priority debts are seen rarely in consumer bankruptcy cases).[47] Section 213 prevents the confirmation of a reorganization plan unless the debtor has paid all domestic support obligations.[48] Section 214 provides that the automatic stay does not prevent legal actions enforcing wage orders for domestic support obligations and similar actions.[49] Section 215 makes nondischargeable all domestic support obligations, including obligations owed to government support agencies. Section 216 permits

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[43]H.R. 975, § 211 (proposed amendment to 11 U.S.C. § 101).

[44]11 USC 523(a)(6).

[45]*Id.*

[46]*See* H.R. 975, § 211 *et seq*.

[47]H.R. 975, § 212 (proposed amendment to 11 U.S.C. § 507(a)). In the current enumeration of priorities, for example, the unsecured claims of person who raise grain or operate fish-processing facilities have fifth priority. 11 U.S.C. § 507(a)(5).

[48]H.R. 975, § 213 (proposed amendments to title 11, United States Code).

[49]H.R. 975, § 214 (proposed amendment to 11 U.S.C. § 362(b)). This includes the interception of tax refunds, the enforcement of medical obligations, or actions to withhold, suspend, or restrict licenses of the debtor for delinquency in support obligations.

nondischargeable domestic support obligations to be collected from property – notwithstanding state laws making that property exempt from collection or attachment – after bankruptcy.[50] Section 217 makes clear that a transfer that was a bona fide payment for a domestic support obligation will not be considered a fraudulent or preferential prepetition transfer.[51] Section 218 specifies that alimony and child support payments are not included in the definition of disposable income in chapter 12 cases. Finally, section 219 of the bill requires trustees to send written notice to recipients of alimony and child support payments, and to the local and state child support agencies, notifying them that a debtor of such payments has filed for bankruptcy.[52]

4. Other Anti-Debtor Provisions

The legislation makes a host of additional changes to the consumer provisions of the bankruptcy laws. The majority of the provisions are designed to increase creditor pay outs and would greatly harm low- and middle-class debtors. As Harvard Law Professor Elizabeth Warren writes, the bill "has more than 120 pages of amendments affecting consumer cases, and they all head in the same direction: They give a few creditor interests more opportunities to try to recover from their debtors while they reduce the protection for other creditors and debtors."[53] In 1999, Chairman Hyde himself noted that the bill contains at least 75 provisions detrimental to debtors and favorable to creditors. Among other things, the bill extends the period permitted between chapter 7 filings from six years (under current law) to eight years;[54] expands the ability of residential landlords to evict tenants without seeking permission from the court;[55] and significantly narrows the definition of household goods exempt from repossession in bankruptcy.[56]

B. Principal Problems with Proposed Changes

1. H.R. 975's Means Testing is Arbitrary and Unworkable in Practice

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[50]H.R. 975, § 216 (proposed amendment to 11 U.S.C. § 522).

[51]H.R. 975, § 217 (proposed amendment to 11 U.S.C. § 547(c)(7)).

[52]Notices to domestic support recipients must also state that they can use the services of a government support enforcement agency to collect the support.

[53]*March 11, 1999 Hearing* (written statement of Professor Elizabeth Warren).

[54]H.R. 975, § 312.

[55]H.R. 975, § 311.

[56]H.R. 975, § 313.

The National Bankruptcy Review Commission's majority specifically rejected the so-called "means testing" approach,[57] observing:

> The credit industry has sought means testing consistently for at least 30 years, but Congress has consistently refused to change the basic structure of the consumer bankruptcy laws. . . . Access to chapter 7 and to chapter 13, the central feature of the consumer bankruptcy system for nearly 60 years, should be preserved.[58]

The 1973 Commission on Bankruptcy Laws similarly considered and rejected industry calls for mandatory chapter 13's, noting that Congress had itself rejected similar proposals in 1967, and observed:

> [B]usiness debtors are not subject to any limitation on the availability of straight bankruptcy relief, including discharge from debts, and it was pointed out that, quite apart from bankruptcy, business debtors are able to incorporate and to limit their liability to their investments in corporate assets. To force unwilling wage earners to devote their future earnings to payment of past debts smacked to some of debt peonage, particularly when business debtors could not be subjected to the same kind of regimen under the Bankruptcy Act. . . . The Commission concluded that forced participation by a debtor in a plan requiring contributions out of future income has so little prospect for success that it should not be adopted as a feature of the bankruptcy system.[59]

The principal problem with the means test is that the rigid one-size-fits-all test used in determining eligibility for chapter 7 and the operation of chapter 13 will often operate in an arbitrary fashion. Many of these flaws were highlighted in 1999 by Chairman Hyde when he unsuccessfully sought to delete the use of the rigid IRS standards and instead substitute a more fact specific test based on the court's assessment of the debtor's actual reasonable and necessary

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[57]Only two members of the National Bankruptcy Review Commission signed onto a dissenting statement supporting the consideration of various means testing options. NATIONAL BANKRUPTCY REVIEW COMMISSION, FINAL REPORT: BANKRUPTCY - THE NEXT TWENTY YEARS (Oct. 20, 1997) (Chapter 5, Additional Dissent to Recommendations for Reform of Consumer Bankruptcy Law Submitted by the Honorable Edith H. Jones and Commissioner James I. Shepard).

[58]*Bankruptcy: The Next Twenty Years,* National Bankruptcy Review Commission Final Report 90-91 (Oct. 20, 1997).

[59]*Report of the Commission on Bankruptcy Laws*, H.R. Doc. No. 137, Part I, 93rd Congress, 158-59 (1973) (citation omitted).

expenses.[60]

Rather than relying on the debtor's actual costs of living, the bill relies upon IRS collection standards, which lay out no comprehensive or specific standards for the deduction of living expenses. Part of the problem arises from the fact that the IRS standards referenced by the bill are not automatic in many cases. Although the IRS does set forth national standards for some expenses, such as food and clothing,[61] and local standards for expenses such as housing and transportation,[62] it leaves the determination of "other necessary expenses" to the discretion of the relevant IRS employee.[63]

Moreover, where the IRS has specific local expense standards, those standards do not always provide adequately for normal expenses. Ironically, Congress itself has recognized the inadequacy of such collection standards. The Internal Revenue Service Restructuring and Reform Act of 1998 directs the IRS to "determine, on the basis of the facts and circumstances of each taxpayer, whether the use of the schedules . . . is appropriate" and to ensure that they not be used "to result in the taxpayer not having adequate means to provide for basic living expenses."[64] However, neither that law nor H.R. 975 grants this safeguard in the bankruptcy context.

The seemingly arbitrary allowances for such expenses points to another problem with the means test under H.R. 975 – its bias against debtors without secured debts. This is because the bill allows all secured debt payments to be deducted from monthly income, but limits rental and lease payments to the amount permitted by the IRS standards. This means that persons renting apartments and leasing cars may not be able to deduct the full amount of their housing and transportation costs in bankruptcy, while persons with mortgages and automobile debt will be

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[60]The Committee had initially approved an amendment offered by Chairman Hyde eliminating the IRS collection standards from the means test. Subsequently, however, Rep. Graham (R-SC) offered an amendment reintroducing the IRS collection standards into the means test; effectively reversing the Chairman's earlier amendment. The Committee accepted this amendment by a 17-14 largely party line vote, with Chairman Hyde and Rep. Baccus (R-AL), crossing party lines to join with most Democrats in opposing the reinsertion of the IRS standards.

[61]IRS Manual § 5323.432.

[62]IRS Manual § 5323.433.

[63]IRS Manual § 5323.12.

[64]Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3462 (1998).

able to do so.[65] There is no legitimate policy rationale for this discrepancy, which appears to punish people who rent and lease and nonetheless had to resort to bankruptcy.

Also, it is important to note that the IRS collection standards can change the manner in which the bankruptcy laws are applied. The collection standards serve as internal guidelines for the IRS; they are not regulations that are subject to the Administrative Procedures Act. As such, the IRS does not need to provide notice or seek public comment when introducing new standards or when changing the existing ones. If the bankruptcy law was amended to incorporate the collection standards, as H.R. 975 proposes, and the IRS were to change the collection standards in the future, the alteration in the standards would completely change how the Bankruptcy Code is applied. In effect, H.R. 975 would delegate authority to the IRS to amend the Bankruptcy Code without notice.

It is no answer to assert, as the legislation's proponents have done, that the "glitches" in the collection standards can be resolved through the bill's allowance that "the presumption of abuse may only be rebutted by demonstrating special circumstances that justify additional expenses or adjustments of current monthly income for which there is no reasonable alternative."[66] This is a new standard with no clear definition. It is unclear how the courts will apply it. Establishing "special circumstances" will be costly and burdensome. Special circumstances may be established only upon a debtor's motion to the court.[67] It is the debtor's burden to show special circumstances. The debtor must present detailed documentation for expenses for adjustments to income and a detailed explanation of the special circumstances which make such expenses or adjustment to income the only reasonable alternative for the debtor. These requirements make it very difficult for debtors to claim special circumstances, since many expenses are paid in cash and cannot be documented. This risk provides a tremendous disincentive for debtors to claim extraordinary circumstances, let alone incur the legal costs the debtor himself is required to pay to bring the motion.

By the same token, the sanctions against creditors who file abusive motions under §707(b) are weak. The court may grant attorney's fees and costs only under a Rule 9011 standard or if the motion was brought *solely* to coerce a debtor to waive bankruptcy rights, an almost impossible standard to meet. (If the motion was brought both for illegally coercive purposes and other purposes, fees would not be awarded.) In motions brought by small

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[65]Higher income debtors can also easily plan around the means test by, for example, purchasing a new expensive car shortly before bankruptcy, or deferring tax and child support payments, thereby increasing priority claims.

[66] §102, new 11 U.S.C. 707(b)(2)(B)(i)

[67]H.R. 975, § 102 (proposed amendment to 11 U.S.C. § 707(b)(2)(B)).

businesses with small claims, no fees are awarded even if Rule 9011 is violated.[68] Conversely, debtors' counsel are subject to both costs and civil penalties, and must certify that the client's statement about her financial circumstances are true.

There are also several serious interpretive problems caused by the drafting of the means test, which combines debt payment amounts with IRS allowances. For example, it is not clear whether a debtor who has two payments remaining on a secured car loan is allowed the IRS car ownership allowance for the remaining 58 months. If not, the debtor may have no funds to replace a car that is already seven or eight years old at the outset of the five year period and is essential for a long commute to work during the 5-year term of the plan.

Finally, making chapter 13 the only avenue for bankruptcy relief for some individuals and imposing the bill's strict income and expense tests will undoubtedly result in an even smaller proportion of successful chapter 13 plans. It is also somewhat unrealistic to expect many chapter 13 cases to result in successful completion of repayment plans. The current chapter 13 completion rate is less than one-third,[69] for chapter 13 plans which are voluntary and with disposable income tests are less rigid than that proposed in this bill. Moreover, changes to ch. 13, such as the elimination of stripdown, will make it more difficult for even debtors who file for ch. 13 voluntarily to confirm or complete a plan.

2. Means Testing Will be Costly and Bureaucratic

The bill's attempt to impose rigid financial criteria on debtors' eligibility for chapter 7 and the operation of chapter 13 will impose substantial new costs on the bankruptcy system – both the portions paid for by private parties (through payment for private chapter 7 and chapter 13 trustees and higher attorneys' fees) and the federal government (through the bankruptcy courts and the U.S. Trustees Program).

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[68] Bankruptcy Rule 9011(b) provides, in part, "By presenting to the court (whether by signing, filing, submitting, or later advocating) a petition pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances ... it is not being presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the costs of litigation."

Under the bill, should a court grant a section 707(b) motion made by a trustee and find that the action of debtor's counsel in filing the chapter 7 case violated Federal Rules of Bankruptcy Procedure 9011, section 102(a) mandates that the court order the attorney to reimburse the trustee for all reasonable costs in prosecuting the motion, including reasonable attorneys' fees. In addition, the court must assess an appropriate civil penalty, payable to the private trustee, bankruptcy administrator, or the United States trustee.

[69] NATIONAL BANKRUPTCY REVIEW COMMISSION, FINAL REPORT: BANKRUPTCY - THE NEXT TWENTY YEARS 90-91 (Oct. 20, 1997).

Testifying about the costs to private trustees, the National Association of Bankruptcy Trustees has complained:

> [U]nder the bill, trustees must (1) review the debtor's income and expenses prior to five days before the § 341 hearing, (2) file a 'certification' that the debtor is qualified to be a chapter 7 debtor at least five days before the § 341 hearing, (3) filed motions to dismiss under § 707(b) where the debtor's disposable income would yield [specified payments] to a chapter 13 trustee over a five-year plan. This is a great deal of work for trustees who only receive $60 in the typical chapter 7 case. In addition, the plight of the trustee is multiplied when, even if he is successful, he cannot count on any compensation.[70]

The most recent CBO estimate of the bill's cost to the federal government is $256 million over the next five years[71]. An additional cost of $18 million is estimated for additional judges necessary to administer the new rules. This estimate was made before the recent recommendations of the Judicial Conference which seeks significantly more judges than are contained in the bill. This request is based on current needs, not on projected needs if the bill passes. Hence the estimate of costs to the judiciary must be considered unrealistically low. Part of this cost estimate derives from implementing the complex and paperwork heavy means testing program. CBO estimates it will cost some $38 million over the next five years[72]. However, this estimate may well be far too low. For example, Henry E. Hildebrand, Chair of the Legislative Committee of the National Association of Chapter Thirteen Trustees estimated that:

> Assuming that one out of nine cases filing for chapter 7 relief would be contested and further assuming that the contest would require about two hours of pretrial preparation and one hour of court time, the litigation would require 276,000 additional hours, about 90,000 of which would occupy the court.[73]

Another source of higher costs for the government is the requirement that one in every

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[70]*March 17, 1999 Hearing* (written statement of Robert H. Waldschmidt, National Association of Bankruptcy Trustees at 3).

[71]Congressional Budget Office, *Cost Estimate: H.R. 333 Bankruptcy Abuse Prevention and Consumer Protection Act of 2001 as reported by the House Committee on the Judiciary on February 26, 2001,* at 1 (February 27, 2001)(Hereinafter referred to as "CBO 2001").

[72]*Id.*

[73]Henry E. Hildebrand, *The Hidden Costs of Bankruptcy Reform* 2 (1998)(unpublished manuscript on file with the Committee on the Judiciary, minority staff).

250 cases in each federal district [74]be randomly audited by independent certified public accountants or independent licensed public accountants, at taxpayer expense under generally-accepted auditing standards.[75] CBO estimated it will cost the federal government $58 million over five years to effectuate this requirement. It is unclear whether such costs will yield any comparable benefits. For example, the Honorable William Houston Brown, a U.S. Bankruptcy Judge in the Western District of Tennessee, testified on behalf of the ABI that the audits required "are likely to be very expensive, and such formal audits are likely unnecessary to determine significant misstatements in debtors' petitions and schedules."[76]

Other costs to the government under the bill include, the costs of the U.S. Trustee certifying the availability of credit counseling ($17 million over 5 years) and requiring the U.S. Trustee to visit sites in chapter 11 cases ($12 million over 5 years).

CBO also found that it would "impose private-sector mandates, as defined by UMRA, on bankruptcy attorneys, creditors bankruptcy petition preparers, debt-relief agencies, and credit and charge-card companies. CBO estimates that the direct costs of these mandates would exceed the annual threshold established by UMRA ($109 million in 2000, adjusted annually for inflation)."[77]

Another concern is the many, many new opportunities for litigation and confusion created by the bill. Judge Randall Newsome testified on behalf of the National Conference of Bankruptcy Judges that at least 16 potential sources of litigation are contained in the means testing provisions alone, and that another 42 litigation points have been identified in the other consumer provisions, noting that "[t]his is probably only the tip of the iceberg."[78]

Costs imposed on the private sector will also be substantial. According to CBO, "H.R. 333 would impose private-sector mandates, as defined by UMRA [the Unfunded Mandates Reform Act] on bankruptcy attorneys, creditors, bankruptcy petition preparers, debt relief

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[74] Henry E. Hildebrand, *The Hidden Costs of Bankruptcy Reform* 2 (1998)(unpublished manuscript on file with the Committee on the Judiciary, minority staff).

[75]H.R. 975, § 603. Although there is broad support for audits, which were a National Bankruptcy Review Commission proposal, the purpose of the proposal (to ensure honesty and accuracy) will fail unless a reasonable requirement is set on the ratio of cases to audit and unless the appropriate substantive standard is applied to the audits.

[76]*March 17, 1999 Hearing* (testimony of the Honorable William Houston Brown).

[77] CBO 2001, at 1.

[78]*March 17, 1999 Hearing* (written statement of the Honorable Randall J. Newsome, President, National Conference of Bankruptcy Judges at 1).

agencies and credit and charge-card companies. CBO estimates that the direct costs of these mandates would exceed the annual threshold established by UMRA ($109 million in 200, adjusted annually for inflation)."[79]

3. Means Testing and the Other Consumer Provisions Will Harm Low- and Middle-Income People

a. Concerns Regarding the Means Test

It is incorrect to assume that the effect of H.R. 975's harmful provisions would be limited to individuals seeking bankruptcy relief who earn more than the regional median income.

The definition of "current monthly income" used in the means test measures a debtor's income based upon how much the debtor earned in the six months prior to bankruptcy. If the debtor lost a good job in month three and has been working at a low-wage job ever since, the income from that good job, and help from family members, would be counted as if that is what his future income would be. The debtor would be expected to pay out of income that may no longer exist. Also, the means test will pickup a variety of revenue sources – such as disaster assistance, and Veterans' benefits – which will result in lower- and middle-income individuals being cast as bankruptcy "abusers" with income above the median.

In addition, due to the fact that H.R. 975, unlike current law, will permit creditors and other parties-in-interest to bring motions to dismiss or convert, more aggressive and well-funded creditors will have extremely wide latitude to use such motions as a tool for making bankruptcy an expensive, protracted, and contentious process for honest debtors, their families, and other creditors. Creditors could use such motions as leverage to obtain reaffirmation agreements so that their unsecured debts survive bankruptcy

The inability to obtain bankruptcy relief will force more families out of the above ground economy and into a permanent state of unmanageable indebtedness.[80]

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[79]CBO 2001 at 1.

[80]A recent study, by the University of Maryland Department of Economics, illuminates the phenomenon of "informal bankruptcy", whereby debtors, especially those who are difficult to find or those with few attachable assets, may choose simply to stop making payments altogether and enter the underground economy. Amanda E. Dawsey and Lawrence M. Ausubel, *Informal Bankruptcy*, U. MD. Dept. Econ., Jan. 2001, at 2. This then puts the burden on the creditors to collect. While informal bankruptcy lacks the legal protections afforded by (formal) bankruptcy, the incentives of informal bankruptcy cannot be underestimated, not the least of which is the lack of any administrative or legal costs initially. Importantly, little consideration has been given to informal bankruptcy with respect to legislation, yet in 1996 some 65.2 % of credit card loans were charged off for reasons other than bankruptcy. 1997 Annual Bankruptcy Survey, Visa U.S.A.

b. Other Concerns

The bill makes nondischargeable a wider range of debts including cash advances and debts incurred for so-called luxury goods and debts incurred to pay nondischargeable tax debts.[81] These new exceptions from discharge obviate many of the benefits that debtors may realize from filing for bankruptcy, under chapter 7 or 13 and increase the opportunity for creditor abuse. The provisions were opposed by President Clinton. In a communication to the Congress, that administration wrote that it is "generally inappropriate to make post-bankruptcy credit card debt a new category of nondischargeable debt. . . . We remain skeptical that the current protections against fraud and debt run-up prior to bankruptcy are ineffective and that the additional debts made nondischargeable by [H.R. 975] meet the standard of an overriding public purpose."[82]

Consumer bankruptcy expert Henry Sommer also has explained that such provisions:

> increase the opportunity for creditors to file the types of abusive fraud complaints which have been found by many courts to be baseless and unjustified attempts to coerce reaffirmations by debtors who cannot afford to defend them. The new presumptions of nondischargeability will fall mainly on low income debtors who are unsophisticated, do not have the time, budget flexibility, or attorney advice to plan their bankruptcy cases carefully, have to file on short notice to prevent utility shutoffs or other impending creditor actions and will not have the funds to defend dischargeability complaints."[83]

The new ban on loan bifurcations for car loans less than 2 years old will further erode the possibility of obtaining a fresh start through bankruptcy.[84] Automobiles depreciate rapidly once they leave the showroom. Before the loan is repaid, the value of the vehicle is less than the unpaid balance of the loan. By prohibiting bifurcation, a lender with a secured loan that is underwater would be unjustly enriched by being able to treat the unsecured portion of that loan

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Inc., September 1998.

[81]H.R. 975, §§ 310 (proposed amendment to 11 U.S.C. § 523(a)(2)(C)), and sec. 314.

[82]Letter from Jacob J. Lew, Director, Office of Management and Budget, to the Honorable Jerrold Nadler, Ranking Member, House Subcomm. on Commercial and Admin. Law 2 (Mar. 23, 1999).

[83]*Hearing on Consumer Bankruptcy Issues in H.R. 3150, the "Bankruptcy Reform Act of 1999," Before the House Subcomm. on Commercial and Admin. Law*, 105th Cong., 2d Sess. (Mar. 10, 1998) (written statement of Henry J. Sommer).

[84]H.R. 975, § 306.

as fully secured to the detriment of other unsecured creditors. Such a prohibition on automobile bifurcation is likely to render many chapter 13 plans unfeasible because a debtor may be able to repay the entire secured value, but not the entire purchase price of the car along with penalties. The provision also permits the lender to come out of the bankruptcy in a superior position than if it had foreclosed on the loan under applicable non-bankruptcy law.

Several other consumer provisions also will impose significant hardships on all debtors, regardless of income level or degree of culpability. For example, by allowing landlords to continue eviction or unlawful detainer actions even after debtors have obtained an automatic stay, the bill will force many battered women and families with children and seniors out onto the streets, without ever having an opportunity to use bankruptcy to catch up on their rent.[85]

Extending the permitted period between bankruptcy filings to eight years[86] exceeds the period between filings set forth in the Bible,[87] and could prove a substantial hardship to families in already unstable economic situations. The bill's narrow definition of exempt household goods could allow creditors to threaten foreclosure on economic necessities, such as personal computers, in order to obtain preferential treatment for itself.[88] This provision would work to the benefit of predatory and subprime lenders that take a security in interest in the borrower's personal effects.

4. The Consumer Provisions Will Have a Significant, Adverse Impact on Women, Children, Minorities, and Seniors, as well as Victims of Crimes and Severe Torts

a. Women and Children

H.R. 975 will have an adverse impact upon single mothers and their children, both as debtors and as creditors. On the debtor side, the means test will make it far more difficult for

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[85]H.R. 975, § 311.

[86]H.R. 975, § 312 (proposed amendments to 11 U.S.C. §§ 727(a)(8), 1328).

[87]The Biblical origin of debt forgiveness may be found in Deuteronomy 15:1- 3: "[a]t the end of every seven years you shall grant a release of debts. And this is the form of the release: Every creditor who has lent anything to his neighbor shall release it; he shall not require it of his neighbor or his brother, because it is called the Lord's release. Of a foreigner you may require it; but you shall give up your claim to what is owed by your brother." In Deuteronomy 15:9, we are instructed, "See that you do not harbor iniquitous thoughts when you find that the seventh year, the year of remission, is near and look askance at your needy countryman and give him nothing. If you do, he will appeal to the Lord against you and you will be found guilty of sin."

[88]H.R. 975, § 313.

women to access the bankruptcy system. For example, women whose average income was at the median during the last 180 days, before the support checks stopped, may be denied access to chapter 7 and forced into restrictive chapter 13 repayment plans. Second, the bill does not exempt child support or foster care payments from the means test definition of disposable income, and does not exclude alimony and child support payments received within six months after filing for bankruptcy from the property of the estate.[89] In addition, the bill will also make it more difficult for women to hold onto the car they need to get to work, or the refrigerator or washing machine they need to care for their families if a creditor claims a security interest in such items.[90] The new nondischargeability categories also are problematic. Even if a mother filing for bankruptcy, who obtained cash advances to purchase basic necessities such as diapers or food, it will be more difficult for her to litigate a credit card company's claim of nondischargeability.[91]

The bill will have a particularly adverse impact on the payment of domestic support to women and children as holders of claims for alimony and child support. These concerns are by no means insignificant given that an estimated 243,000-325,000 bankruptcy cases involved child support and alimony orders during the most recent years.[92]

Under current law, alimony and child support are treated as priority debt and are not subject to discharge.[93] This preferential treatment dates from as early as 1903 and is based on Congress's determination that the payment of these debts is so important to society that it should come ahead of most general creditors. Although H.R. 975 does not revoke this special treatment, viewed as a whole, the legislation will have the effect of diminishing the likelihood of full payment of alimony and child support. This arises as a result of several features of the bill: its creation of significant new categories of nondischargeable debt, the extension of the length and onerousness of chapter 13 plans, and the bill's general limitations on the availability of chapter 7 relief.

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[89]H.R. 975, § 102.

[90]H.R. 975, §§ 310, 314.

[91]H.R. 975, § 310.

[92]The reported data are from the Consumer Bankruptcy Project, Phase II. Principal researchers are Dr. Teresa Sullivan, Vice-President of the University of Texas; Jay Westbrook, Benno Schmidt, Chair in Business Law, University of Texas; and Elizabeth Warren, Leo Gottlieb Professor of Law, Harvard Law School. These estimates are based on data collected in 1991 in 16 judicial districts around the country. For more details about the study, see Teresa Sullivan et al., *Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981-91*, 68 AM. BANKRUPTCY L.J. 121 (1994).

[93]11 U.S.C. §§ 507(a)(7) & 523(a)(5).

Each one of these changes will make it less likely that a former spouse will be able to make his required alimony and child support payments. First, by making significant amounts of credit card debt nondischargeable, more of these debts will survive bankruptcy. Since most chapter 7 and 13 debtors do not have the ability to repay most of their unsecured debts, financial pressure on the debtor will continue after bankruptcy, decreasing his ability to handle important support obligations.

Collectively considered, these changes will help foster an environment where unsecured and credit card debt is far more likely to compete against alimony and child support obligations in the state law collection process. As a Congressional Research Service Memorandum analyzing predecessor legislation concluded under [a predecessor] bill "child support and credit card obligations could be 'pitted against' one another. . . . Both the domestic creditor and the commercial credit card creditor could pursue the debtor and attempt to collect from post-petition assets, but not in the bankruptcy court."[94]

Outside of the bankruptcy court is precisely the arena where sophisticated credit card companies have the greatest advantages. While federal bankruptcy court enforces a strict set of priority and payment rules and generally seeks to provide equal treatment of creditors with similar legal rights, state law collection is far more akin to "survival of the fittest." Whichever creditor engages in the most aggressive tactic – be it through repeated collection demands and letters, cutting off access to future credit, garnishment of wages or foreclose on assets – is most likely to be repaid. As Marshall Wolf has written on behalf of the Governing Counsel of the Family Law Section of the American Bar Association, "if credit card debt is added to the current list of items that are now not dischargeable after a bankruptcy of a support payer, the alimony and child support recipient will be forced to compete with the well organized, well financed, and obscenely profitable credit card companies to receive payments from the limited income of the poor guy who just went through a bankruptcy. It is not a fair fight and it is one that women and children who rely on support will lose."[95]

It is for these reasons that groups concerned with the payment of alimony and child support have expressed their strong opposition to the bill and its predecessors. Professor Karen Gross of New York Law School stated succinctly that "the proposed legislation does not live up to its billing; it fails to protect women and children adequately."[96] Joan Entmacher, on behalf of the National Women's Law Center, testified that "the child support provisions of the bill fail to ensure that the increased rights the bill would give to commercial creditors do not come at the

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[94]CONGRESSIONAL RESEARCH SERVICE, IMPACT OF CONSUMER BANKRUPTCY REFORM PROPOSALS ON CHILD SUPPORT OBLIGATIONS (May 13, 1998).

[95]Statement of Marshall J. Wolf (May 13, 1998) (on file with the House Comm. on the Judiciary).

[96]*March 18, 1999 Hearing* (written statement of Karen Gross, New York Law School).

expense of families owed support."[97]

Assertions by the legislation's supporters that any disadvantages to women and children under H.R. 975 are offset by supposedly pro-child support provisions are not persuasive. It is useful to recall the context in which these provisions were added. In the 105th Congress, the bill's proponents adamantly denied that the bill created any problems with regard to alimony and child support.[98] Although the proponents have now changed course, the child support and alimony provisions included do not respond to the provisions in the bill causing the problem – namely the provisions limiting the ability of struggling, single mothers to file for bankruptcy; enhancing the bankruptcy and post-bankruptcy status of credit card debt; and making it more difficult for debtors to eliminate debts and focus on domestic support obligations. In some instances, the new sections are counterproductive in furthering the goal of payment of support obligations to ex-spouses and children.

For example, section 211 provides a definition of "domestic support obligation" that includes funds owed to government units.[99] If the government is acting as the debt collector for a woman or child, this is appropriate; the benefits of this inure to women and children directly. However, if the government is collecting for its own benefit (say, for example, the woman recipient is on welfare and the government is collecting arrearages to reduce a state or Federal deficit), then the result is inappropriate and will put the government collection agency in direct competition with single mothers and children, particularly in chapter 13.[100]

Section 212 purportedly increases to first priority from seventh priority obligations for domestic support, including debts owed to the government. It is misleading to suggest that moving up to "first priority" from "seventh priority" makes a significant difference: the debts that have second through sixth priorities almost never appear in consumer cases.[101]

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[97]*Id.* (written statement of Joan Entmacher, National Women's Law Center).

[98]Letter from Representative George W. Gekas, et al., to Members of Congress (Apr. 29, 1998).

[99]Under current law, domestic support owed to families is a priority debt; support owed to the government is nondischargeable, but is not priority debt.

[100]Although the bill gives priority to support claims owed to actual people over those owed to the government in chapter 7 cases where there are assets to distribute, those cases are few, and the new definition could serve to hurt women and children, the most likely creditors of domestic support.

[101]Those priorities – which would likely apply in less than 1% of all cases – deal with debts of grain storage facility operators, debts of fishermen, employee wage claims, retail layaway claims, and the like. 11 U.S.C. § 507(a).

In most cases, the place in the priority order is meaningless. In ch. 13, all priority debts must be paid in full.[102] In approximately 97% of all individual ch. 7 cases, the debtor has no non-exempt assets and so is unable to pay any priority or non-priority unsecured debts, regardless of their placement in the priority order. Outside bankruptcy, of course, the priorities in the Bankruptcy Code are inapplicable and unenforceable. It is in state court, after the case is over that the mother must compete with newly non-dischargeable credit card debts. Being first priority is of no help.

Section 214 creates additional exceptions to the automatic stay[103] that, like other provisions in the bill, have the potential of placing women and children at a disadvantage. First, these provisions apply only to income withholding orders issued by government agencies under the Social Security Act, even though an estimated 40-50% of all child support cases, and all alimony-only cases, are enforced privately, not by government child support agencies. Second, income withholding is helpful only if such orders are placed against debtors with regular income. Yet, in 1997, more than four out of ten cases in state child support systems across the country lacked a support order.[104]

Section 216, which allows domestic support creditors to levy otherwise exempt homesteads and other exempt property, also does not go far enough. Like the other provisions, it is effective only if a single mother goes to the time and expense of hiring an attorney to enforce her new rights.

The legislation also totally ignores another very serious problem facing women as a result of the Bankruptcy Code – the fear that violent and reckless individuals will be able to terrorize and blockade abortion clinics and eliminate their liability from that action through the bankruptcy process. Although the current bankruptcy laws prevent discharge for "willful and malicious injuries,"[105] Supreme Court precedent has raised doubt whether this standard applies

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[102] 11 USC 1332(a)(1).

[103]H.R. 975, § 214 (proposed amendment to 11 U.S.C. § 362(b)). Specifically, the bill creates exceptions to the automatic stay for enforcement actions undertaken by government child support agencies, including income withholding in cases being enforced by public agencies; actions to withhold, suspend or restrict drivers', professional and occupational, or recreational licenses; reporting overdue support to credit bureaus; intercepting tax refunds; and enforcing medical support.

[104]*March 18, 1999 Hearing* (written statement of Joan Entmacher, National Women's Law Center) (citing U.S. DEPT. OF HEALTH AND HUMAN SERVS., OFFICE OF CHILD SUPPORT ENFORCEMENT, PRELIMINARY DATA REPORT: CHILD SUPPORT ENFORCEMENT FY 1997 (Aug. 1998).

[105]11 U.S.C. § 523(a)(6).

to a clinic bombing where a particular victim was not targeted.[106] It is also unclear whether the law applies to damages resulting for barricading clinic entrances. At the same time, notorious clinic bomber and "Operation Rescue" found Randall Terry specifically filed for bankruptcy in order to void a $1.6 million judgment he owed to the National Organization for Women and Planned Parenthood,[107] and many of the notorious "Nuremberg files" defendants have filed for bankruptcy.

Although a bankruptcy discharge has proved elusive for these law-breakers, they have succeeded in abusing the bankruptcy courts to hinder, delay and defraud the women whose rights they have violated, imposing substantial costs on them to collect lawful judgements.

As NARAL Pro-Choice America has written, "[d]ebtors whose debts arise from their own clinic violence are not honest debtors and should not be able to escape the financial liabilities incurred by their illegal conduct."[108]

b. Minorities, Seniors, and Victims of Crimes and Severe Torts

H.R. 975 will have a disparate impact upon minorities and victims of crimes and torts, also. The Leadership Conference on Civil Rights has warned that, under the predecessor legislation, "African American and Hispanic American families, suffering from discrimination in home mortgage lending and in housing purchases and facing inequality in hiring opportunities, wages, and health insurance coverage [will be less able to] turn to bankruptcy to stabilize their economic circumstances."[109] We know this because the economic struggle for Hispanic American and African American homeowners is harder than for any other group. While 68% of whites own their own homes, only 44% of African Americans and Hispanic Americans own their homes. Both African American and Hispanic American families are likely to commit a larger fraction of their take-home pay for their mortgages, and their homes represent virtually all their family wealth. It is no surprise, then, that African American and Hispanic American homeowners are six hundred percent more likely to seek bankruptcy protection when a period of

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[106]Kawaauchau v. Geiger, 523 U.S. 57 (1998) (holding that the actor must intend the consequences of the act, injury to someone or something, not just the act, itself). If, therefore, the actor intends only to damage the building and not any person inside, but does injure a person inside, he may be able to discharge the debts arising out of the injury to the person because that injury was not intended. *See id.*

[107]*Operation Rescue Founder Files for Bankruptcy due to Lawsuits*, WASH. POST, Nov. 8, 1998, at A29; *An Anti-Abortion Leader Files for Bankruptcy*, N.Y. TIMES, Nov. 8, 1998, at 45.

[108]Memorandum of NARAL 8 (Mar. 30, 1999).

[109]Letter from LCCR to Members of Congress (Apr. 21, 1999).

unemployment or uninsured medical loss puts them at risk for losing their homes.[110] Experience has also shown that minorities are also particular targets of predatory lenders.

Similar concerns have been raised on behalf of seniors, who could lose their retirement savings if forced into chapter 13 plans.[111] The National Council of Senior Citizens has warned that legislation of this nature:

> would have a harsh impact on a group of people who are often subject to job loss or catastrophic health costs; instead of ameliorating these problems, this bill will only exacerbate them. . . . Since 1992, more than a million people over the age of 50 have filed for bankruptcy; in 1997, an estimated 280,000 older Americans filed. For them it is particularly hard. If they are forced into prolonged repayment schedules, they may not be able to maintain or accumulate savings for retirement. As you know, approximately two third of voluntary Chapter 13 workout plans fail, and we believe that retirement savings must be protected for that purpose.[112]

With regard to the concerns of victims' groups, it is important to note that current law reserves the nondischargeability of debts for obligations arising out of willful or malicious injury, death or personal injury caused by the operation of a motor vehicle, or criminal restitution payments.[113] However, making more credit card debt nondischargeable, encouraging more reaffirmations of general unsecured debt, and discouraging more financially troubled individuals from seeking debt relief will place these individual creditors at a relative disadvantage. As the National Organization for Victim Assistance has written, "more exempted creditors with rights to the same finite amount of resources means lower payments to all. Inevitably, for victim-creditors, that means either a smaller return on the restitution owed, or a longer period of repayment, or both."[114] The National Center for Victims of Crime has similarly observed, "to equate contractual losses of a commercial creditor with . . . personal obligations [for victim claims as the legislation does] is to belittle their importance and to directly reduce the likelihood that crime victims will ever be financially restored, despite obtaining an order of restitution or a

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[110] *Id.*

[111] Letter from Dan Schulder, Director Legislation, National Council of Senior Citizens, to the Honorable Jerrold Nadler, Ranking Member, House Subcomm. on Commercial and Admin. Law (June 9, 1998).

[112] *Id.*

[113] 11 U.S.C. §§ 523(a)(6), (9), (13).

[114] Letter from Marlene A. Young, Executive Director, NOVA, to the Honorable Henry J. Hyde, Chair, House Comm. on the Judiciary (Apr. 26, 1999).

civil judgment."[115] Mothers Against Drunk Driving ("MADD") has also complained that if "individuals [whose lives] have been shattered financially and emotionally by the death or serious injury of their family members . . . have to compete with credit card debt holders for the limited post-discharge income of debtors available [as the predecessor legislation requires], they may themselves end up in bankruptcy."[116] MADD also noted that in contrast to crash victims, "lending institutions have the ability to provide some degree of protection to themselves when they issue credit cards to individuals and they are in a better financial position to absorb losses, which to them is a cost of doing business."[117]

5. The Bill Does not Address Abuses of the Bankruptcy System by Creditors

Perhaps the bill's most glaring omission is its failure to fully address the problem of abusive lending practices. At the same time the legislation responds to every conceivable debtor excess – whether real or imagined – it largely ignores the transgressions of the credit industry. The only significant "reform" with regard to lending industry disclosure is that requirement that credit card companies provide the consumer with an "800" number to call and unrealistic examples of credit card debt paydowns (which may not reflect the actual situation of the debtor and thus prove misleading), as well as a series of boilerplate warnings regarding real estate loans and teaser rates.[118]

As noted at the outset, the overwhelming weight of authority establishes that it is the massive increase in consumer debt, not any change in bankruptcy laws, which has brought about the increases in consumer filings. Indeed, there is an almost perfect correlation between the increasing amount of consumer debt and the number of consumer bankruptcy filings. For example, between 1993 and 1998, bank credit card loans in the United States more than doubled from $223 billion to nearly $500 billion, and personal bankruptcy filings increased accordingly.[119] The same basic correlation holds from 1946 through 1998, as the below chart

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[115]Letter from David Beatty, Director of Public Policy, The National Center for Victims of Crime, to the Honorable Jerrold Nadler, Ranking Member, House Subcomm. on Commercial and Admin. Law (Apr. 28, 1999).

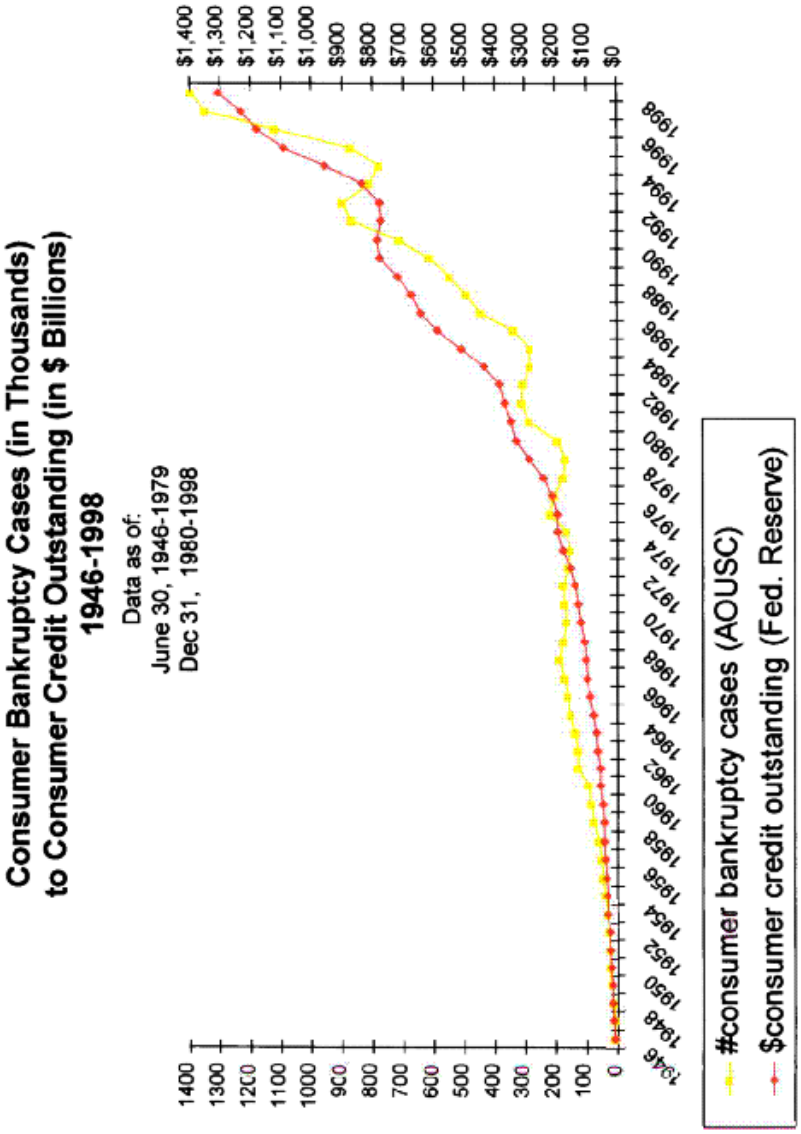
[116]Letter from Karolyn V. Nunnallee, National President, MADD, to Members of Congress (Apr. 26, 1999).

[117]*Id.*

[118]H.R. 975, Title XIII.

[119]*March 16, 1999 Hearing* (written statement of Joe Lee, Charts 5-6). In 1993, banks issued credit card loans in the amount of $223 billion; in the same year, there were approximately 900,000 consumer bankruptcy filings. *Id.* (citing the FDIC and the Administrative Office of the

indicates:



U.S. Courts). In 1998, banks issued $455 billion in credit card loans; that year, there were 1.4 million consumer bankruptcy filings. *Id.*

Review of this data indicates that the primary factor that led to the increase in bankruptcy filings after 1978 was not the enactment of the revised bankruptcy laws, but the deregulation of credit. The deregulation resulted from the Supreme Court decision in *Marquette National Bank of Minneapolis v. First Omaha Service Corp.*,[120] which held that out-of-state banks were not subject to the usury laws of the state where the consumer was located. This decision led credit card concerns to relocate to states with lax usury laws that gave banks the ability to charge exorbitant interest rates in all 50 states. Subsequently, other legal changes permitted a broad range of new entities to get into the ever-growing, and lucrative, credit card business.[121] Among other things, we know that it was this unprecedented increase in high-cost credit, not the changed bankruptcy laws, that led to the change by virtue of Canada's experience. In Canada, bankruptcy filings began to explode in the late 1960's, simultaneous with the entry of VISA and MasterCard into that nation and the growth in credit card lending. There was no change in Canada's laws that could account for the increase.[122]

This deregulation of credit and the accompanying explosion in credit availability – the number of credit card solicitations in 1998 reached 3.5 billion, an increase of 15 percent from the prior year[123] – and consumer debt, have been accompanied by a wide variety of credit card abuses. For example, solicitations of minors and college students are a particular problem. Credit card companies purposefully solicit students and other minors who have little ability to pay their debts. Illustrative of the seriousness with which credit card companies target students is the following topic from the 1998 Card Marketing Conference:

> Targeting Teens: "You Never Forget Your First Card!" Most teens never forget their first love. Nor do they forget the issuer who dares to accept their application. Their brand loyalty and propensity to spend make consumers in their mid- to late-teens priced prospects for many card issuers.[124]

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[120]439 U.S. 299 (1978).

[121]*See March 16, 1999 Hearing* (written statement of Hon. Joseph Lee at 1-3).

[122]*Id.* (written statement of Hon. Joseph Lee at 4-5).

[123]Press Release of the National Consumer Law Center, Consumers Union, Consumer Federation of America, and U.S. PIRG (Apr. 19, 1999).

[124]*Id.* (quoting Agenda for Card Marketing Conference '98 (Nov. 9-11, 1998)). Between 1990 and 1995, the average student credit card debt more than doubled from $900 to $2,100. By 1997, graduate students averaged seven cards and carried a total balance of $5,800. That's in addition to school loans, which are increasingly being used to pay off students' credit card debt. To support average post-college debts and other expenses, graduates need to earn more than $38,000 --- $4,000 more than the national average. ("Bankrupt at 24, Susan Carpenter, LA

The credit card tactics are myriad, including offering gifts such as mugs, Slinkees, T-shirts, and Frisbees.[125] Campus groups managing credit card tables receive large cash payments from credit card companies.[126] Such tactics apparently work, as 61% of students responsible for their own bills have indicated that they received credit cards at college.[127] Some colleges have become so fed up with card marketing practices that they banned the credit card companies from their campus[128] – although they cannot stop mail solicitations.

Credit card companies even go so far as to solicit business from the developmentally disabled.[129] One developmentally disabled man, aged 35, has the reading and mathematic skills of a second-grader and an annual income of $7,000 from Social Security disability benefits; nevertheless, he has 13 credit cards, generating a debt of $11,745.[130] When his counselor asked the bank to lower his credit limit to $500, his limit was instead raised to $4,900.[131] Credit card companies have no answer for how this occurs other than to say that they screen all applicants to ensure they can handle the risk.[132] Clearly, however, credit card companies have not been doing a sufficient job of screening their applicants. Unfortunately, H.R. 975 does nothing to discourage any of these practices.

The bill also ignores the problem of credit card companies lending to individuals with already substantial debts and little prospect of repayment. Gary Klein of the National Consumer Law Center noted "offering additional credit . . . to families already struggling to pay their debts hurts not only borrowers, but also the borrowers' honest creditors if the new credit pushes the family over the edge. Similarly, failure by one creditor to seriously consider payment

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Times January 24, 2001.)

[125]*Id.*

[126]*Id.*

[127]U.S. PUBLIC INTEREST RESEARCH GROUP, THE CAMPUS CREDIT CARD TRAP: RESULTS OF A PIRG SURVEY OF COLLEGE STUDENTS AND CREDIT CARDS (Sept. 1998).

[128]Press Release of the National Consumer Law Center, Consumers Union, Consumer Federation of America, and U.S. PIRG (Apr. 19, 1999).

[129]Dan Herbeck, *Where Credit Isn't Due: Developmentally-Disable Become Victims*, BUFFALO NEWS, Apr. 7, 1998, at 1A.

[130]*Id.*

[131]*Id.*

[132]*Id.*

arrangements outside bankruptcy for families facing hardship may lead to a bankruptcy filing which affects all creditors."[133] One credit card company goes so far as to solicit debt counselors and offers them $10 for each chapter 7 client who requests a VISA card.[134]

A particularly pernicious credit card practice occurs in the so-called "subprime" market, where lenders seek out riskier borrowers and offer home equity financing at loan to value ratios in excess of 100%. Another lending abuse targets low income and minority neighborhoods with "serial" refinancing loans that carry high interest rates and other onerous terms.[135] In essence this causes poor individuals to place their homes at risk in order to finance their credit card purchases.

These problems are compounded by the fact that credit card companies fail to disclose clearly on their account statements the total amount and total time it would take to pay off balances if only the minimum amount due was paid each month.[136] Unlike mortgage loans and car loans, credit card loans do not disclose the amortization rates or the total interest that will be paid if the cardholder makes only the minimum monthly payment. As a result, using a typical minimum monthly payment rate on a credit card, it could take 34 years to pay off a $2,500 loan, and total payments would exceed 300 percent of the original principle. This is why many lenders encourage minimum payments that do not pay down the loan.[137]

Finally, the legislation fails to address adequately the problem of abuse in the area of reaffirmation agreements, by for example, placing effective and meaningful restrictions on their

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[133]*March 11, 1999 Hearing* (written statement of Gary Klein, National Consumer Law Center).

[134]Letter from American Bankruptcy Service to Michael Schwartz (Dec. 18, 1998).

[135]March 18, 1999 Hearing (written statement of Damon A. Silvers, AFL-CIO, n.9 [citing Debra Nussbaum, "*Lenders Laud the Value of Home Sweet Equity*," N.Y. TIMES, Mar. 22, 1998, § 3 at 10; Richard W. Stevenson, "*How Serial Refinancings Can Rob Equity*," N.Y. TIMES, Mar. 22, 1998, § 3 at 10. *See also* Julia Patterson Forrester, "*Mortgaging the American Dream: A critical Evaluation of the Federal Government's Promotion of Home Equity Financing*," 69 TULANE L. REV. 373 (1994)]).

[136]Section 112 of the bill requires only that credit card companies disclose on customer account statements that making the minimum payments each month will increase the length of time it takes to pay off the account. This "disclosure" provision is meaningless because it would not require credit card companies to tell customers exactly how long it would take, and how much it would cost, if the minimum payments were made.

[137]*March 16, 1999 Hearing* (written statement of Frank Torres, Consumers Union).

use with respect to unsecured and dischargeable loans. [138] Although it requires lengthy and confusing "disclosures," it exempts credit unions from any restrictions on unduly burdensome reaffirmations, defined as requiring the debtor to make monthly payments in excess of 100% of the debtor's post-discharge monthly disposable income[139]. This failing is especially glaring in view of the fact that the bill will provide numerous opportunities for creditors to coerce reaffirmations making the provisions of this bill, which will render it more difficult to obtain effective remedies against abusive creditors like Sears, even less defensible.[140]

Neither the witness representing the Credit Union National Association, nor any proponent of the bill has ever attempted to explain why a credit union should be permitted to reaffirm a debt requiring payments that, as a matter of simple arithmetic, the debtor will be unable to pay. This provision is unconscionable and runs counter to the historic commitment of credit unions as defenders of the rights of their members.

III. SMALL BUSINESS AND SINGLE-ASSET REAL ESTATE PROVISIONS

Under current law, businesses may use chapter 11 of the Bankruptcy Code in an effort to obtain relief from the creditors while they seek to develop a plan to reorder their affairs and pay as much of their debts as their operations will allow. Under this chapter, businesses obtain an "automatic stay," which forestalls creditor collection efforts. During this time period, debtors have an opportunity to examine their contracts and leases and determine which ones to assume and which ones to reject (with rejection leading to a claim for damages). Debtors are subject to a number of requirements during this period, such as the formation of creditor committees and various ongoing financial disclosures.

The goal of chapter 11 is to determine whether there is ongoing business value that can be preserved to pay off creditors, while maintaining as many jobs and contractual relationships as possible. To this end, the debtor is given an exclusive 120-day period (unless lengthened or shortened for cause) in which to develop a reorganization plan that satisfies a host of statutory requirements and convince a majority of the creditors that the plan is in their best interests and is preferable to a liquidation "fire sale."

In 1994, Congress enacted two exceptions to the general rules of chapter 11. The first related to "small businesses," defined as entities engaged in commercial or business activities

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[138]The bill fails to effectively address the problem with reaffirmation agreements, since it provides for court review in only a limited group of cases and allows creditors to refuse to disgorge funds received even if a reaffirmation was illegal in many cases.

[139]Sec. 203(a) (creating a new 11 USC 524(m)).

[140]*See* Leslie Kaufman, *Sears to Pay Fine of $60 Million in Bankruptcy Fraud Lawsuit*, N.Y. Times, Feb. 10, 1999, at C2.

whose aggregate debts do not exceed $2 million. Debtors that elect to be treated as small businesses are permitted to dispense with creditor committees, receive only a 100-day plan exclusivity period, and are entitled to more flexible provisions for disclosure and solicitation for acceptances of their proposed reorganization plan.

In 1994, Congress also developed a special set of rules applicable to "single asset real estate," generally defined as cases in which the principal asset is a single piece of real estate subject to debt of no more than $4 million. In cases falling within this definition, secured creditors are permitted to foreclose on their collateral unless the debtor files a reorganization plan which is likely to be confirmed or commences payment on the secured loan within a 90-day period. This exception to chapter 11 procedures was justified on the grounds that single asset real estate cases were seen as essentially private two-party loan disputes, which did not implicate ongoing businesses or jobs.

A. Small Business Provisions

The business provisions of the bill would effectuate a number of changes in the manner in which corporations, partnerships and other business entities are permitted to reorganize their financial affairs. With respect to small business, H.R. 975 would expand the definition of covered small business to those companies having debts of less than $3 million,[141] subsuming more than 80% of all chapter 11 cases.[142] It would also make the small business requirements mandatory (rather than optional) and mandate the operation of numerous additional requirements on debtors.[143] For example, under H.R. 975, small business debtors would be required to provide balance sheets, statements of operations, cash-flow statements, and income tax returns within three days after filing a bankruptcy petition, the time period the debtor has the exclusive right to file a plan of reorganization would be modified (to 180 days without the possibility of extension), and the standards for being able to seek an extension of this time period would be substantially narrowed.[144]

It is for these reasons that the AFL-CIO, and a number of other organizations representing both debtor and creditor interests are opposed to, or have serious concerns with, the small business provisions of the bill. The AFL-CIO has warned that the small business provisions in the bill will "threaten jobs by placing substantial procedural and substantive barriers in the way of small businesses' access to the protections of Chapter 11; . . . threaten jobs by

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[141]H.R. 975, § 432 (proposed amendment to 11 U.S.C. § 101(51D)).

[142]*See March 18, 1999 Hearing* (written statement of Jere W. Glover, Chief Counsel for Advocacy, SBA).

[143]H.R. 975, § 436 (proposed 11 U.S.C. § 1116).

[144]H.R. 975, § 437 (proposed amendment to 11 U.S.C. § 1121(e)).

requiring commercial debtors to assume or reject commercial leases within a rigid timetable, which would force debtors to favor one class of creditors over others, and threaten their overall ability to successfully reorganize."[145] All of these concerns are compounded at a time we are experiencing an economic slowdown, if not an outright recession.

This new bankruptcy mandate, particularly sections 437 through 439, would impose substantial new costs on small businesses, both in terms of document production and legal fees, and limit the time frame that the business has to develop a reasonable reorganization plan.[146] Section 437 provides an absolute limit on the period the business debtor has the exclusive right to file a plan of reorganization. Congress has previously enacted laws that have made it far more difficult for debtors to unduly delay filing a plan of reorganization, and these appear to have had a salutary effect. The proposed rigid deadline goes much farther and could work to detriment of debtors involved in complex reorganizations and force unnecessary liquidations and job losses. In turn, these changes will lead to the premature liquidation of small businesses with the attendant loss of jobs. The provisions are particularly unnecessary at a time when business bankruptcies have declined by one-third over the most recent ten-year period.[147]

Describing the earlier version of the bill, the SBA's Office of Advocacy summed up the situation as follows: "the proposals in [the legislation] go too far in addressing the relatively small number of problem cases."[148] Even more dangerously, it has been noted that many – if not most – of the business cases in the average district would fall prey to these harsh new rules.[149]

B. Single-Asset Real Estate Provisions

A similar concern relates to single-asset real estate ("SARE") debtors. The legislation would significantly expand the definition of SARE by eliminating the $4 million debt cap pursuant to a "technical correction" in section 1201(5) of Title XIII of H.R. 975, would take in

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[145]Letter from Peggy Taylor, Director of Legislation, AFL-CIO, to the Honorable Henry J. Hyde, Chair, House Comm. on the Judiciary (Apr. 20, 1999).

[146]*March 18, 1999 Hearing* (written statement of Jere W. Glover, Chief Counsel for Advocacy, SBA).

[147]Letter from Jere W. Glover, Chief Counsel for Advocacy, U.S. Small Business Administration, to the Honorable Jerrold Nadler, Ranking Member, House Subcomm. on Commercial and Admin. Law (Apr. 22, 1998).

[148]*March 18, 1999 Hearing* (written statement of Jere W. Glover, Chief Counsel for Advocacy, SBA).

[149]*Id.* (written statement of Damon A. Silvers, AFL-CIO at 4); *March 17, 1999 Hearing* (written statement of Kenneth Klee, National Bankruptcy Conference at 7).

SARE bankruptcies below that cap and treat them as small businesses.

As a result of these changes, a much wider range of real estate operations would be required to conform with the SARE and small business requirements when they seek to reorganize, notwithstanding the fact that those requirements were drafted with a much smaller and simpler entity in mind. Large operating entities such as Rockefeller Center, as well as hotels and nursing homes, could be considered SARE and put back on the track set forth in § 362(d)(3) of the Bankruptcy Code. It would also create new incentives for lenders to require that all of their real estate borrowers place their holdings in the single asset form in order to avoid ordinary bankruptcy rules in the future. The AFL-CIO noted, "the significant limiting factor in the application of these rules has been the $4 million cap. [Eliminating] the cap would place a wide variety of properties . . . at risk of foreclosure and threaten jobs at these properties. Absent rules that specifically exclude properties such as housing and those with significant business enterprises, there should be no expansion in the definition of single asset real estate debtor."[150]

By design, the SARE changes will "broaden the scope of single asset real estate debtors subject to rules which increase the threat of disruptive summary foreclosures of commercial property."[151] This, in turn, would likely lead to significant job losses.[152] Even if a hotel or nursing home remains in existence, the new owner would not necessarily be required to honor any previously negotiated collective-bargaining agreements applicable to employees at the facility. In the case of a large real estate operation, premature foreclosure could also allow the new owner to terminate many leases, leading to further job losses to the extent the business is relying on these leases.

C. Other Business Concerns

A host of additional concerns have been raised by groups such as the AFL-CIO and the National Bankruptcy Conference regarding the business titles of the legislation. These include concerns about the expansion of remedies available to secured creditors in the transportation

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[150]*March 18, 1999 Hearing* (written statement of Damon A. Silvers, Associate General Counsel, AFL-CIO).

[151]Letter from Peggy Taylor, Director of Legislation, AFL-CIO, to the Honorable Henry J. Hyde, Chair, House Comm. on the Judiciary (Apr. 20, 1999).

[152]*Id.*

industry;[153] the imposition of mandatory deadlines for extensions of "exclusivity";[154] amendments regarding asset securitization limiting the assets available to a debtor during a bankruptcy case;[155] limits on subsequent filings for troubled small businesses,[156] and provisions giving utility companies an enhanced position in bankruptcy.[157] In general, the AFL-CIO has warned that "the real danger posed by H.R. 833 [the precursor to H.R. 975] is the threat it poses to our economy's ability to weather downturns. The bill aims to make access to the bankruptcy process more difficult for our economy's most vulnerable links – small businesses and consumers. This will likely result in increased business closures, job loss and home foreclosure, increasing the severity and length of any future economic downturn."[158]

Similar concerns relate to the power of creditors who lease retail property. Section 404 unfairly grants lessors of commercial property the ability to coerce debtor-tenants into deciding prematurely whether to assume or reject a lease. In a retail insolvency, a debtor may need to wait beyond the 210-day period – 120 days with the ability to gain a 90-day extension upon a motion for cause and with the lessor's consent – until the holiday season is complete to determine which locations have a realistic chance to succeed; a trustee or debtor in possession may decide to assume and reject some of the leases based upon this practical experience.[159] If the trustee or debtor in possession assumes a nonresidential lease in chapter 11, and the case subsequently converts to chapter 7, under the bill, the rent due for a one-year period following rejection of the lease becomes an administrative expense for compensation, gaining priority over all other unsecured claims and limiting the opportunity for other unsecured creditors to receive compensation.[160] By giving the lessor veto power at the end of 210 days, as the bill now does, the legislation would have the effect of giving a single creditor inordinate bargaining power

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[153]*March 18, 1999 Hearing* (written statement of Damon A. Silvers, AFL-CIO); *March 17, 1999 Hearing* (written statement of Kenneth Klee, National Bankruptcy Conference).

[154]H.R. 975, § 411.

[155]H.R. 975, § 912.

[156]H.R. 975, § 441.

[157]H.R. 975, § 417.

[158]Letter from Peggy Taylor, Director of Legislation, AFL-CIO, to the Honorable Henry J. Hyde, Chair, House Comm. on the Judiciary (Apr. 20, 1999).

[159]The value to the estate of retaining the ability to assign certain leases is often a significant issue in determining which leases to assume or reject because it impacts upon the ability to pay other creditors. It should also be noted that the lessor already is entitled to get paid post-petition rent for the use of the property – the debtor is not using it for free.

[160]*In re Klein Sleep Prods.*, 78 F.3d 18 (2d Cir. 1996).

among creditors and with the debtor.

Another problematic provision appears in section 442 of H.R. 975. Section 442 amends section 1112(b) of the Code to expand the grounds on which the court can dismiss or convert a small business case. For example, a case will be presumptively dismissed when the debtor fails to comply with a lengthy list of requirements. To overcome the presumption, the debtor must show that a reasonable justification exists for the debtor's action, that the debtor will rectify the situation within a reasonable time prescribed by the court, and that the plan will be confirmed within a reasonable period of time. Again, the concern is that § 442 may be too inflexible and could be used by some creditors to obtain leverage over other creditors,"[161] or the case could be converted to ch. 7 when it may have successfully reorganized, costing jobs and sacrificing going concern value for the creditors and the estate.

IV. TAX PROVISIONS

The Bankruptcy Code seeks to effectuate a delicate balance between the rights of the Internal Revenue Service and state tax agencies to the repayment of any taxes, interest, and penalties owed them, and the rights of other creditors and the ability of individuals and corporations to be financially rehabilitated for the benefit of all parties. Title VII of the bill, on balance, manifests a strong preference for the IRS and other taxing authorities to the detriment of other participants in the bankruptcy system. Concerns have been expressed that, not only does H.R. 975 generally enhance the rights and position of the IRS and state authorities in bankruptcy, but the bill grants the IRS certain rights in bankruptcy cases that it does not enjoy outside of bankruptcy, and vests the IRS with new enforcement powers that ordinary creditors do not posses.[162] Of particular concern is the fact that the bill varies in many significant respects from the nonpartisan, and often unanimous, recommendations of the Bankruptcy Commission and its Tax Advisory Committee.

Title VII of the H.R. 975 deals with the treatment of tax debts owed to the government by a debtor. It is ironic that the bill, whose sponsors have normally taken such an anti-tax posture on most issues, not only uses the IRS collection standards for the means test but also presses for changes to the Bankruptcy Code that favor governmental collections over the rights of debtors and private sector creditors.

Arguably one of the bill's most important provisions affecting business bankruptcies appears in Section 708 of Title VII. This section provides that a corporation will not be discharged from a tax or customs duty where the debtor made a fraudulent return or willfully

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[161]National Bankruptcy Conference, Report on H.R. 2415, 106th Cong., 2d Sess (H. Rept. 106-970) at 17 (2001).

[162]*Hearing on Business Bankruptcy Issues Before the House Subcomm. on Commercial and Admin. Law*, 105th Cong., 2d Sess., (Mar. 18, 1998) (statement of Paul H. Asofsky).

attempted to evade or defeat the tax or duty. More significantly, by referencing any debt in section 523(a)(2) of the Code, the provision even would encompass claims that were fraudulently incurred that are *not* tax claims. In its critique of section 708, the National Bankruptcy Conference wrote:

> A rule such as the one proposed in §708 advantages one creditor at the expense of others. It is a recipe for certain mischief, especially in large reorganizations. There is no public policy reason to grant this kind of leverage to some creditors as the purpose in making these assertions transparently will likely be to obtain a better deal that other creditors.[163]

In addition, Paul Asofsky, who served as the Chair of the Task Force on the Tax Recommendations of the National Bankruptcy Review Commission of the American Bar Association's Tax Section, testifying about H.R. 833 on behalf of the American Bar Association's Section on Taxation, observed that: "[T]here are many provisions in this legislation with which we agree as a matter of principle, but the specific provisions are either ambiguously drafted or cut against the grain of the principal proposal, causing us to oppose what should be noncontroversial proposals."[164]

Mr. Asofsky provided a somewhat more detailed discussion of his concerns in a letter to the Subcommittee's Ranking Member.[165] Section 704 of H.R. 975 provides for a significantly higher uniform interest rate to be applied to tax claims in a bankruptcy case. The Tax Advisory Committee, which included governmental representatives, concluded that the rate for all types of tax claims should be the regular tax deficiency rate for federal income tax purposes. The bill, however, provides that the rate shall be determined by applicable bankruptcy law. Of greater concern, local governments can set their own interest rates, many of which are substantially higher than either of the IRS rates.[166]

Section 707 severely limits the "superdischarge" available to debtors in chapter 13. It would prevent a debtor from discharging tax debts, which is now permitted in chapter 13, but not in chapter 7. Eliminating the benefit of the superdischarge also eliminates the single greatest incentive for an individual debtor to choose chapter 13. As Mr. Asofsky observed,

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[163]National Bankruptcy Conference, Report on H.R. 2415, 106th Cong., 2d Sess (H. Rept. 106-970) at 16 (2001).

[164]*March 18, 1999 Hearing* (written statement of Paul Asofsky).

[165]Letter from Paul Asofsky to the Honorable Jerrold Nadler, Ranking Member, House Subcomm. on Commercial and Admin. Law (Feb. 5, 1999) [hereinafter Asofsky Letter].

[166]*Id.* at 3-4.

> [T]he problem faced by many taxpayers who are delinquent in their obligations is that the IRS standard allowances for installment payment agreements[167] clearly do not leave many taxpayers with the minimum amounts necessary to provide for basic necessities, and so called "offers in compromise" are very difficult to obtain. Thus, for the most desperate of taxpayers, the chapter 13 superdischarge affords a safety net which is the only thing that provides them with the possibility of living somewhat of a normal life in dignity ... elimination of the chapter 13 superdischarge would be devastating to large numbers of unfortunate individual debtors.[168]

Section 717 requires disclosure of the tax consequences of a chapter 11 plan of reorganization. Although originally an uncontroversial idea, the bill adds extra requirements which will likely cause confusion and may be impossible for debtors to comply with fully. The section now requires "a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interest in the case." The use of a vague term such as "discussion" – although an improvement over the requirement in the earlier version of a "*full* discussion" – will likely lead to extensive litigation as these statements are scrutinized. In some instances, the precise tax consequences of a plan at all levels of government, and for a "typical" holder of claim, may be difficult to produce with great precision.[169]

Finally, section 718 requires that a debtor actually have commenced an action against the taxing authority to determine the amount of a disputed tax before a setoff can be prevented. Absent such an action by the debtor, a governmental entity generally is free to "setoff" any prepetition refund with a liability. The Advisory Committee had recommended that such setoff should only be permitted in cases where the liability was undisputed. The bill goes much further and to the disadvantage of the debtor and other, non-governmental creditors.

V. CORRUPTION OF THE BANKRUPTCY SYSTEM:

Although the legislation purports to wring fraud and abuse from the bankruptcy system, there are a number of provisions which will open the door to further abuse by certain parties.

Section 324 of the bill would overturn the result in the *Merry-go-Round* case in which the accounting firm of Ernst and Young was for fraud, fraudulent concealment, and negligence/malpractice for its conduct while serving as restructuring accountants and business advisors in the Merry-go-Round bankruptcy. The suit was brought in the Circuit Court for

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[167]These are the same standards used in the means test in section 102 of H.R. 975.

[168]Asofsky Letter at 4.

[169]*Id.* at 5-6.

Baltimore City, but Ernst & Young attempted to move the case to the bankruptcy court. The case was remanded back to state court and the remand was ultimately upheld by the District Court.[170] Faced with a jury trial in state court, Ernst & Young ultimately settled the case with the trustee for $185 million.

The import of the *Merry-Go-Round* case is the issue of holding professionals, such as accounting firms, accountable for their actions in a bankruptcy case. As professionals, they are paid by funds from the estate before other creditors. They have a duty to the estate and the creditors. When they violate that duty, they can be denied fees by the bankruptcy court, or they may face an action for damages. Damages paid to the trustee are made available to the creditors.

This change in the law was inserted for the express purpose of insulating accountants and other professionals from facing the consequences of their wrongdoing. At a time when public policy is moving in the direction of greater accountability, there is no excuse for this change.

Section 414 would relieve investment bankers of the duty of being disinterested persons before they can be retrained as professionals by the trustee. The disinterestedness standard, which has been in existence since 1938, protects the estate from conflicts of interest by professionals in the case. Judge Edith Jones of the U.S. Court of Appeals for the Fifth Circuit has written, "such a standard can alone protect integrity in the bankruptcy process. If professionals who have previously been associated with the debtor continue to work for the debtor during a bankruptcy case, they will often be subject to conflicting loyalties that undermine their foremost fiduciary duty to the creditors. Strict disinterestedness, required by current law, eliminates such conflicts or potential conflicts ..... Section 414, in removing investment bankers from a rigorous standard of disinterestedness, is out of character with the rest of this important legislation, however, and it should be eliminated."[171]

Section 102 relieves certain creditors and their attorneys from penalties prescribed in the bill even if they violate Bankruptcy Rule 9011. As discussed earlier, there is never a justification for violating BR 9011. Granting such an exception would only encourage inexcusable abuse of the process. Moreover, because this exception is embedded in the attorney sanctions portion of the individual debtor provisions of this bill, it would open the door to creditors abusing the most vulnerable debtors with impunity. There are many instances in which this legislation makes such abuse possible. Enshrining this sort of exemption in the law exemplifies the dangerous distortion of the bankruptcy system this bill represents.

For these reasons, we believe that H.R. 975 should not become law.

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[170] *In re: Merry-Go-Round Enterprises, Inc. (Ernest & Young, LLP v. Devan)*, 222 B.R. 254 (D. Md. 1998).

[171] *Letter to Hon. F. James Sensenbrenner*, (Hon. Edith H. Jones)(March 11, 2003).

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